

Municipal Bond Market Development

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Part I

Municipal Bond Market Development in Developing Countries: The Experience of the U.S. Agency for International Development

Part I

Municipal Bond Market Development in Developing Countries: The Experience of the U.S. Agency for International Development

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Introduction

Throughout the 1990s, assistance provided by the U.S. Agency for International Development (USAID) to developing countries in the field of urban development has focused increasingly on expanding the financial resources available to local governments. Under the rubric of municipal finance, USAID has worked with central governments, local governments, and institutions intended to support the municipal sector in two general areas: (1) municipal sector finance: strengthening the financial management and financial condition of local governments; and (2) municipal finance systems: improving the financing systems that local governments use to carry out essential activities and services. The emphasis throughout has been on improving the ability of local governments to provide basic services that improve the public health and the economic health of urban residents, especially potable water, wastewater collection and treatment, and solid waste management. Depending on the roles and responsibilities of local governments, the need for investment in streets and local roads, markets, terminals, electricity, and other functions has also been addressed.

Prominent among several strategies used to expand municipal finance systems pursued by USAID with its foreign counterparts, has been a number of efforts to develop municipal bond markets. The U.S. municipal bond market is known worldwide for its ability to provide seemingly unlimited long-term capital to the municipal sector for a wide range of purposes, and for that reason USAID and its consultants have responded to numerous requests in countries with urban sector activities to bring the U.S. experience to bear on emerging municipal finance systems.

This report is a summary of the experiences of USAID in the development of municipal bond markets, and in the development of more general market-based municipal finance systems, in eight countries: the Czech Republic, India,¹ Indonesia, the Philippines, Poland, Russia, South Africa, and Zimbabwe. Although the experiences represented vary greatly in terms of longevity, focus, and results, as a whole they present a rich and fairly complete picture of the range of issues being confronted in the field of emerging market municipal finance. The extent of these activities varies from India and Indonesia, where activities leading to bond market development have been carried out for several years; to South Africa, where assistance has focused on

¹ Additional information about India's bond markets can be obtained from USAID's Financial Institutions Reform and Expansion Program: Financing of Urban Infrastructure Through Debt Markets (no case study was available).

restarting and reorganizing an existing market to reflect the realities of the post-apartheid era; to Zimbabwe, where activities to date have been largely diagnostic.

Part I is intended, first, to give a brief overview of the motivation of USAID and its counterparts in choosing municipal finance and bond market development as development strategies. A development framework is also included that attempts to illustrate the extent and content of USAID's municipal finance market development activities. A brief technical summary of each country's activities is provided, followed by two concluding sections: a list of findings to date from the activities reviewed, and a review of ongoing and future issues in this field. The report concludes (Part II) with case studies from each of the countries discussed in Part I.

The Changing Situation of Local Governments and Their Financing Options

A number of global trends are contributing to the increasing interest in developing financial mechanisms, including financial market access, for local governments. First among these is decentralization—that is, changes in the way responsibility for a wide range of government functions is shared between local and central governments. In general, the role of local government is expanding and that of central government declining, especially in the area of basic service provision. Among the factors driving the decentralization trend are rapid urbanization in many developing countries, which is putting great pressure on the demand for services; and the growing desire to increase the responsiveness of government at all levels to its citizenry.

Other influences on the demand for local finance have to do with changes in the systems whereby funding for basic services has been provided historically. Traditional sources have included funds from official development assistance (World Bank, USAID, etc.), central government transfers to local government and central government soft-credit facilities, and “pay as you go” financing from both central and local sources. These sources are no longer adequate; official development assistance has fallen over time both absolutely and relative to demand, central governments are under pressure to improve fiscal balance by reducing central budget expenditures, and pay-as-you-go schemes not only restrict critical current expenditures but also simultaneously fail to raise sufficient capital for major investment projects.

The changing role of the private sector, particularly the financial sector, in many developing countries has also had an impact on the range of financing options open to local governments. Two related trends in particular, privatization and financial markets development, have had a positive influence. The effort to privatize an array of government functions, including local government services in some cases, has accelerated financial markets development in a number of countries and pressured local governments to consider ways to improve the quality and viability of service provision.

Even where privatization is not being pursued, improvements in the size, efficiency, and competitiveness of financial and capital markets have not gone unnoticed by the local governments. Knowing that local governments in developed countries have access to financial and capital markets, local officials worldwide are asking why they too cannot be served in this way. In a minority of cases, financial sector officials themselves have recognized the enormous need for capital that exists in the municipal sector and have begun investigating how they can tap into this potential new customer base. Local governments may be depositing funds with private financial institutions and taking advantage of lines of credit and short-term lending options for equipment. However, almost universally, the lack of information, including systems

for evaluating credit quality, and the lack of appropriate credit mechanisms impede the connection between the municipal and financial sectors that is necessary for municipal finance transactions to develop. These are among the market failures USAID projects have attempted to address.

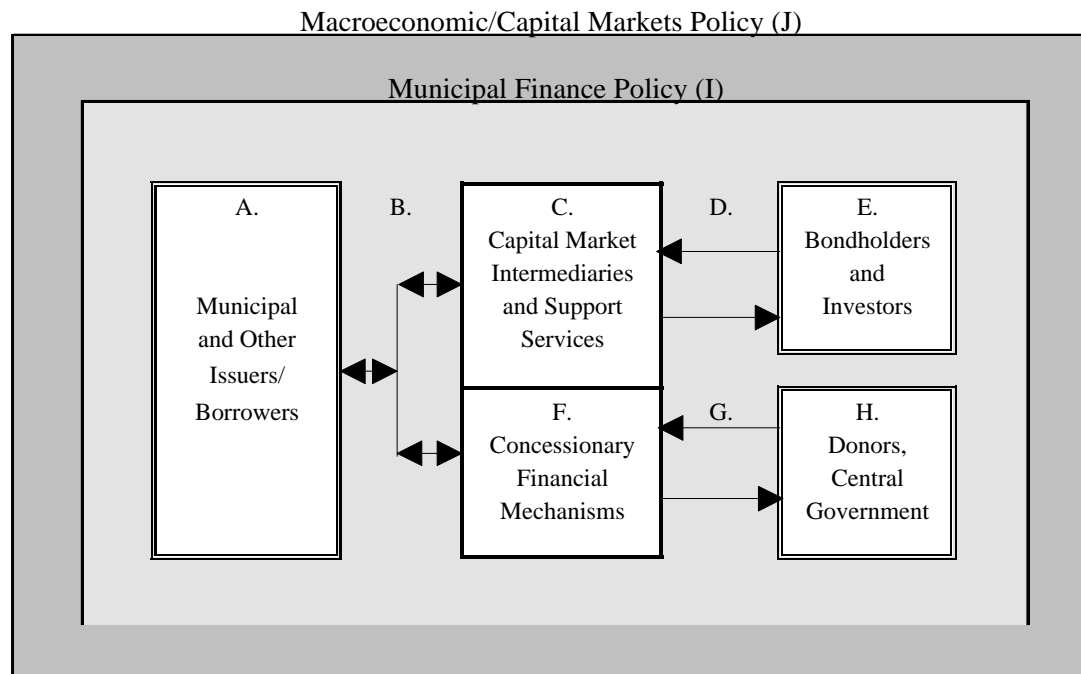
Defining Municipal Financial Market Development

The desire to introduce a particular instrument such as municipal bonds into a developing country financial market can be a very complex undertaking. Whereas in a developed market such as the United States the introduction of a new instrument requires research, sales, and occasionally revision to existing legislation, such an introduction in an emerging market may require development of elements of the market itself. This has been USAID's experience in attempting to introduce municipal bonds into a number of new markets. Figure 1, below, is an attempt to capture the range of activities that have been carried out with USAID sponsorship under the general heading of municipal finance market development and in connection with the introduction of municipal bonds.

Box A represents effective demand for municipal finance by municipalities and their instrumentalities, and potentially by pooled financing vehicles raising funds on behalf of municipalities (a concept discussed later). Many local governments are either not adequately creditworthy or are not yet familiar with the range of activities that precede the issuance of municipal bonds or other borrowing (improving the financial condition of municipalities, developing cost-recovery schemes, improving accounting and reporting standards, preparing capital budgets and demand forecasts for services). Most of the municipal finance projects discussed in this report have included a component to address the need to strengthen these capacities of local government; in some cases these activities have been a major focus of USAID's work.

Box B in the diagram covers the process whereby projects are prepared and structured, funding sources are identified, and funds are borrowed and later repaid. Because of the inexperience of many local governments with borrowing, especially under disciplined credit terms, or from market-based intermediaries, both the identification of funding sources and the structuring of viable projects can be very difficult and time-consuming for them. The diagram shows municipalities accessing simultaneously both market-based and concessionary funding sources (C and D) in order to fully fund projects. This illustration reflects the reality of many of the projects for which market funding is being sought in emerging economies: co-financing with other funding sources, including concessionary loans and grants, is often required in order for any market financing to be viable. The co-financing may be "equity" provided to the project by the local government from its own reserves, or may include funds from a number of other lenders and grant providers. Development projects have used a range of strategies to address the obstacles encountered at this stage, including providing project preparation resources that allow the hiring of project development expertise.

Figure 1
Elements of Municipal Bond Market Development



**Institutional
Context**

Municipalities
Public Authorities
Public Enterprises
Pooled Financing
Vehicles

Investment Banks
Commercial Banks
Municipal Banks
Credit Enhancers
Credit Rating Agencies
Trustees
Bond Counsel

Institutional Investors
Retail Investors
Financial Institutions
Municipal Banks
Central Government
Donors

Box C represents an array of activities having to do with the financial intermediation process itself, broadly defined. In most countries, capital market players (assuming they exist) generally do not approach the municipal sector spontaneously to offer access to markets. These relationships have to be built at the same time that municipalities are trying to become more attractive investments for these institutions. Activities have included: support for the development of municipal ratings criteria, identification and structuring of credit enhancement mechanisms, events to orient bond counsel and investment banks to the needs of the municipal sector, the creation and/or reform of institutions, and pilot projects to issue municipal bonds.

Step D (and Box E) represent investors and their demands for market investment vehicles. Designing and marketing of municipal securities are activities that would be expected to be carried out by financial institutions themselves once they are sufficiently convinced of the merits of the municipal market. Historically in many countries, investors, especially institutional investors and public sector institutions, have been required to purchase securities of the public sector, and it is this type of prescribed investment regime that this era of municipal finance

hopes to avoid. The objective is to identify the investment needs of both retail and institutional investors and to craft instruments well-suited to the needs of both them and the issuers in the municipal sector. Results in this arena are often beyond the influence of USAID's municipal development projects, being affected by national tax and interest rate policy and other controls that may distort incentives to save and invest. However, the existence of secondary markets may positively influence the decision to buy long-term securities, and USAID has carried out some work in this area. Macroeconomic factors are further discussed under (J) below.

F, G and H show the intermediation process of concessionary financing. The process in some ways parallels that of market intermediation, in the sense that it entails specific institutions that have their own funding sources, underwriting procedures, and information requirements. Much of this financing has historically been, and continues to be, allocated to projects as grants, or if as loans, according to nonmarket considerations, such as poverty rates, population levels, or political influence. But a significant amount of funding from concessionary sources is being used to leverage private finance or to expand incentives to finance privately. It is these latter resources that are represented here, in an effort to demonstrate the need to provide concessionary finance in a market context according to carefully designed principles that take their lead from the market. Development activities in this area have included attempts to reform the lending criteria of public sector lenders and other donors, to develop efficient public/private co-financing mechanisms, and to graduate borrowers from public to private sector funding sources.

Municipal bond market development takes place in the context of at least two levels of finance policy: municipal finance policy (Box I) and macroeconomic and financial sector policy (Box J), both of which greatly influence the rate of municipal bond market or other municipal finance market development.

"Municipal finance policy" is used here to refer to that range of policies that influence the ability of local governments to plan investments, manage themselves financially, raise revenues, take on indebtedness, and otherwise relate to the financial sector. A finance policy framework includes legal elements (municipal law, capital markets law, privatization law, etc.), but is based extensively on policy statements and agreements between the levels of government. A comprehensive municipal finance policy would address the range of financial conditions found within the municipal sector and would identify ways to provide a basic level of resources to governments of all means. It also would include accurate multiyear estimates by sector of the level of demand for finance by local government, and identify appropriate funding sources for these demands, including both local and central government contributions, private finance, and privatization, taking into account the dual objectives of equity and financial market development. A good municipal finance policy provides direction and transparency and lays out roles and expectations for the central government, the municipal sector, and the private sector in the municipal finance field.

Few countries have in place a municipal finance policy as comprehensive and transparent as that described above (South Africa may be the one exception); more common is a patchwork of policy statements and laws that guide municipal finance, which may be contradictory and out of date. This is especially true where significant fiscal decentralization is taking place. In nearly every country covered in this report, therefore, resources have been spent to improve the policy environment for municipal finance, thanks to the benefits that have been seen to accrue from this work over time.

Macroeconomic and financial sector policy also exert enormous influence on the ability of municipal bond markets to develop and the municipal sector to successfully borrow. In fact, this is also a wide range of laws and policies, referred to collectively here for simplicity. These policies affect the competitiveness of the financial sector, the options financial institutions can present to the market, and the relationships among financial institutions and between these institutions and the central government. They influence inflation rates, the term of financial instruments offered, interest rates, exchange rates, and the cost of foreign exchange coverage. They also affect the flows of capital into and out of the country and therefore the level of market liquidity, and the incentives for investors and savers to purchase certain instruments. This complex policy framework affects the rate at which the municipal market will develop and the options available in the market, and ultimately determines the economic viability of municipal investments under consideration.

The development activities described in these case studies generally address macroeconomic and financial sector policy only to a limited extent. Traditionally at USAID, capital markets development activities have focused largely on equity (stock) market development, so even where the larger fiscal and macroeconomic policy issues may be addressed within a USAID Mission, they tend not to concern debt (especially municipal debt) markets development. Considering the impact of these policies on bond market development, this omission might be considered a weakness in a number of the projects discussed.

This finding points out one of the complexities for USAID of municipal bond market development as a development strategy. As Figure 1 demonstrates, a systematic approach requires intervention in a large number of areas, with a broad range of counterparts and collaborators. Such a project would also cross a number of technical areas and could easily require resources in excess of those available in many Missions. In many cases, USAID municipal finance projects rely on other institutions and programs to address issues that fall well outside of the municipal sector.

Strategic Context for Municipal Bond Market Development at USAID

The Role of USAID

USAID supports its counterparts' requests to improve financing options for municipalities with two primary tools: grants for technical assistance and dollar loans from the Urban and Environment (UE) lending program (formerly the Housing Guarantee or HG program). Grant funds are used to deliver technical assistance directly to local governments, to support policy reform at the central government level, or to assist in the development or reform of financial institutions serving the municipal sector. UE loans have been used to support municipal sector and municipal financial market development (including bond market development) in a variety of ways, some of which are discussed in the accompanying case studies. However, the range of strategies to date has been limited to those that can be supported with dollar credits under the UE program. That range of options will soon be augmented by a new credit mechanism, the Development Credit Authority (DCA), which is expected to provide USAID with greater flexibility for the enhancement of financial transactions.

Municipal Finance Within the USAID Strategic Framework

As part of its recent reengineering effort at USAID, each country Mission and Washington Bureau must specify the strategic objectives of its development activities and align its individual program activities with these objectives. An aspect of this process has been an expanded process of consultation with government and other counterparts about USAID's programs. As a result, the strategic objectives of USAID closely reflect development objectives of the countries where they are taking place, and provide insight into the local motivations behind the municipal bond market development activities discussed in this report.

As shown in Table 1 below, municipal bond market development activities are designed and carried out for reasons that span the development spectrum. In the Czech Republic, these activities were seen as contributing to a larger economic restructuring effort that included privatization and economic restructuring. In India, financial sector reform, including municipal bond market development, was seen as a way to mobilize capital, and, it is assumed, to support economic growth. In Indonesia, local governments are seen as key players in the improvement of urban environmental conditions, including the lack of water, and financial resources therefore sought to assist them in carrying out these responsibilities. A secondary objective in Indonesia is fiscal decentralization and the strengthening of municipal-level institutions, especially water authorities.

In the Philippines, municipal finance activities were carried out to support efforts to improve governance at the local government level. It has been concluded in the Philippines, and elsewhere, that without the necessary resources, local governments cannot respond to the demands of citizens, and citizen confidence in local government is undermined as a result.

Table 1. Municipal Bond Market Development: USAID Strategic Objectives

Country	Objective
Czech Republic	Economic restructuring.
India	Increased mobilization of capital through financial sector reform.
Indonesia	Strengthened urban environmental management.
Philippines	More responsive democratic institutions with greater citizen participation.
Poland	Increasing the effectiveness, responsiveness, and accountability of local government. Development of competitive, market-oriented financial sector.
Russia	A more competitive and market-responsive financial sector.
South Africa	Improved access to environmentally sustainable shelter and urban services for the historically disadvantaged population.
Zimbabwe	Encouraging broad-based economic growth.

Poland's municipal finance activities are intended to accomplish both democracy-building and market development objectives. In Russia, also, financial sector development is the motivation for supporting bond market activities.

South Africa's goal in providing support for municipal finance activities (as well as for the privatization of municipal services) is to improve the environmental conditions under which the disadvantaged population lives. And in Zimbabwe, both housing and municipal finance activities are pursued in an effort to improve the country's rate of economic growth through investment in basic infrastructure and shelter.

Technical Summary of Municipal Bond Projects

Appendix A to Part I consists of tables that summarize the specific municipal bond market development and related activities carried out with USAID support in the countries covered by the report. These activities are discussed in greater detail in the eight case studies in Part II.

The amount of new bonds issued to date as a result of the activities described in this report is modest. Municipal bonds have been issued in connection with USAID-support activities in Poland and the Czech Republic. In Russia, bonds were already being issued for housing purchases at the time USAID assistance was provided; there have been some recent improvements in bond terms.

In South Africa, the Infrastructure Finance Corporation has been issuing bonds and onlending the proceeds to municipalities since February 1996, supported partially by funds from the HG program. Ahmedabad Municipal Corporation in India is expected to issue bonds within the next few months; however, financial market conditions have resulted in a halt to bond activities in Indonesia. Activities in Zimbabwe remain in a preliminary stage, with a limited number of bonds still being issued under a government guarantee regime.

USAID Experience with Municipal Bonds: Lessons Learned

Although the activities that are supported by USAID in connection with municipal bond market development and that are described in this report are diverse, there are a number of patterns that emerge. Based on the collective experience gained to date in these projects, the following lessons and conclusions are offered:

- 1. Market-based municipal finance is constrained by the condition of the overall financial system.**

Whereas the development strategy of issuing municipal bonds has at times been pursued under the belief that bond issuance, by itself, has the ability to deepen and lengthen financial markets, it has become clear—conversely—that markets constrain the ability of municipal bonds to provide financing. In the past, long-term finance was available to local governments only as the result of central government guarantees. Increasingly, as these guarantees disappear, the only hope for long-term finance is financial sector reform that builds confidence in markets and mechanisms that allow financial instruments to be traded.

2. **Central governments have an essential role, but it is different from the past role.**

Central governments are moving from being guarantor and the sole allocator of financial resources (generally its own as well as donor resources) to the municipal sector, to a more complex situation in which it has a number of critical roles to play in a coordinated way if municipal finance systems are to develop. Some of the most important roles for central government include: (1) its participation in (if not orchestration of) the development of the municipal finance policy framework; (2) development of macroeconomic and financial sector policy that provides proper incentives for private financing of municipal investments when appropriate; and (3) strategic allocation of concessionary funding to ensure that it does not undermine market development or discourage municipalities from improving their internal financial conditions.

3. **Lack of information may impede market development more than any other single factor.**

Information is the “grease” that keeps financial markets working smoothly; it allows private firms to identify new markets, investors to select and monitor investments, and municipalities to communicate their condition and performance and to measure progress. All of these actions need to take place if municipal finance markets are to develop. Many forms of information are important, including: credit rating criteria and ratings, accounting standards, disclosure standards for the issuance of bonds and other financial instruments, and systems for demand forecasting and performance measurement.

4. **The U.S. bond insurance model has limited applicability, yet credit-enhancement opportunities permeate the municipal finance system.**

In general, U.S. and international bond insurers can operate only in countries with investment-grade sovereign ratings, which eliminates many of the emerging markets. The bond insurance model of the United States may be replicable within other countries, but there are a number of hurdles. In many countries there is not a large enough volume of municipal debt to create an adequate pool. Even if the pool is large enough, the risks may not be diverse enough and predictable enough to provide the necessary “portfolio effect.” In addition, the benefits for municipalities from buying insurance may be minimal since underdeveloped market interest rates do not closely reflect credit risk, making adequate pricing difficult.

But many other credit-enhancement options exist within emerging municipal finance systems, including mechanisms both “internal” and “external” in nature. Internal enhancements are those such as rate covenants and flow-of-funds agreements that improve the structure of a particular financing. External enhancements, such as intercept arrangements and escrow accounts, allow external resources of the issuer to be used to the lower repayment risk of lenders.

5. Transactions and system development are best pursued simultaneously.

All these projects demonstrate the type of long-term commitment required to accomplish municipal bond market development, and the evolutionary nature of the work. However, projects can often be financed even while full market development continues; in fact, attempts to finance projects in underdeveloped markets often point out where particular policy or institutional weaknesses exist that can then be more specifically addressed. A concern arises with how the additional costs of transactions in inefficient emerging markets are to be covered, to ensure that municipalities willing to attempt early transactions are not penalized for being first. A pattern is found in a number of these projects that those responsible for system development and policy reform are often also structuring projects, at least in the early stages, sometimes with minimal early input from the financial sector. How to bring the transaction experience of the private sector to bear on these uniquely difficult projects, at reasonable cost, is a challenge still to be met.

6. Project identification/preparation is a weak link in the project financing process.

Local governments find project identification and preparation difficult for both technical and financial reasons. A number of strategies have been tried to overcome this hurdle to project financing: technical assistance for municipal officials on the project preparation process, technical assistance related to specific projects, and provision of grant or soft loan funds for hiring private consultants. Even privatization is sometimes perceived as a solution to this potential obstacle. Yet even projects slated for privatization must go through a preparation phase. One question is whether it is an effective use of resources to attempt to instill project preparation skills in every local government, when in many cases the process may be carried out fairly infrequently. Pooled financing vehicles are sometimes identified as a compromise between in-house capacity development and private provision of project preparation services. These mechanisms may be able, among other things, to both develop and hire the skills needed and take some of the project preparation burden off of local government officials.

7. Privatization and municipal financing strategies should be coordinated.

While privatization of urban infrastructure and urban services is often proposed as an alternative to municipal financing, experience shows that it is better thought of as a complementary strategy that needs to be incorporated into an overall municipal finance strategy. Privatization takes many forms, from simple contract service provision to full ownership of facilities. Municipal financing may be combined with some forms of privatization, and in some cases privatization may make municipal financing more feasible—for instance, if it makes the operation of a particular function more financially successful. What should be avoided, and has been experienced, is a situation in which no coordinated strategy exists and those responsible for expanding municipal finance and privatization find themselves “competing” to provide resources to some of the same municipal services.

8. Incentives, not institutions.

A financial instrument such as a municipal bond succeeds in a market not on principle, but because buyers and sellers (and others involved in its issuance and sale) have an incentive to keep it available—sellers because it is a cost-effective way to raise funds, buyers because the risk and return are at least as good as other investments in the market of similar term, and others because their involvement in its issuance and sale is profitable. Establishing the array of institutions necessary to issue and sell bonds does not create a municipal bond market; the market is the complex set of incentives that allow the process to take place on a sustainable basis. For private institutions to assist in the development of these markets, there must be adequate financial returns. For creditworthy municipalities to be willing to graduate to market finance from concessionary finance, there must incentives as well, in terms of access to a larger pool of funds, lower interest rates, or perhaps other forms of encouragement from central government. Alternatively, creditworthy municipalities will try (and often succeed at) accessing concessionary financing, and the pace of market development will be slowed.

Ongoing and Future Concerns

Finally, as municipal bond market development activities continue and expand, there are a number of issues that still need to be addressed. Based on the case studies included in this report, and other experiences, the following list briefly identifies a few of the questions and open issues in the field of municipal bond market development:

- How can deal flow be increased in newly-forming markets? *Deal flow is important to market development.*
- Are market-making mechanisms a useful tool in the absence of well-functioning secondary markets? *The ability to trade is important to market development for long-term instruments.*
- Can there be municipal bonds without tax exemption?
- What are the legal risks for municipalities issuing municipal bonds? *The legal framework for municipal bonds is poorly developed and legal exposure of local governments not well understood.*
- How much collateral is available? *Oversecuritization of financing is a potential problem.*
- Cost recovery, revenue sources, rate covenants.
- How can central government transfers be used to support bond issuance?
- Are bond market intermediaries, such as multi-project or pooled financing vehicles of value in emerging markets?

Appendix A

Technical Aspects of USAID Bond Market Projects

	India	Indonesia
Project Name	Financial Institutions Reform and Expansion-Debt Component (FIRE-D)	Municipal Finance Project
Macroeconomic Policy	None.	Under reform.
Capital Markets Policy	FIRE-Equity project focusing on larger financial markets trading and institutional issues.	Prior work on legal reform (ELIPS), capital markets supervision and stock market development.
Municipal Finance Policy	Working within municipal sector. National Institute of Urban Affairs collaborating to focus debate on policy issues. Bottom-up approach.	Extensive policy work, including changes in Regional Development Account and implementation of fiscal decentralization.
Demand Side—Bondholders	Assisting IL&FS, serving as underwriter. Familiarization of financial sector.	Marketing and information dissemination related to municipal bond program.
Capital Market Interventions	Collaboration with CRISIL on development of municipal ratings criteria. Potential capitalization of market-making mechanism.	Support for development of municipal credit criteria by PEFINDO, local credit rating agency.
Supply Side—Bond Issuers	Technical assistance and training for municipalities and policymakers.	Extensive training and technical assistance to water authorities (PDAMs).
Financial Resources	\$125 million Housing Loan Guarantee with IL&FS and HUDCO.	\$100 million policy-related Housing Loan Guarantee.
Results	Ahmedabad bond issuance imminent at end of 1997 and others close to issuance. Certain legal issues not fully resolved.	Increasing share of local government financing decisions under local control. No bonds issued, due partially to financial market deterioration.

Appendix A, continued

	Philippines	Poland
Project Name	Decentralized Shelter and Urban Development	Housing Finance and Municipal Advisory Program
Macroeconomic Policy	None.	Under other projects.
Capital Markets Policy	Encouraging tax exemption of municipal bonds.	Under other projects.
Municipal Finance Policy	Work on reform of Local Government Code.	Extensive assistance.
Demand Side—Bondholders	Limited premarketing activities.	Some marketing/premarketing.
Capital Market Interventions	Involved financial institutions in structuring of Naga City bond.	Support for commercial bank lending to municipal sector, supplying long-term funds. Feasibility of bond market development, bond disclosure guidelines, and issuance procedures.
Supply Side—Bond Issuers	Assistance with project preparation in Naga City. Supported formation of Local Government Credit Finance Association.	Extensive assistance: Creation of Municipal Development Agency, training on capital planning and financial management.
Financial Resources	Prior \$30 million in Housing Loan Guarantees.	\$10 million Housing Loan Guarantee.
Results	No bond issues to date. Concern about incentives created by Municipal Development Fund.	Zł 1,300 million to date.

Appendix A, continued

	Russia	Czech Republic
Project Name	Municipal Finance and Management (+ Housing Sector Reform Project)	Municipal Infrastructure Finance Program
Macroeconomic Policy	Through other projects.	Limited.
Capital Markets Policy	Municipal finance only. Other interventions through other projects.	Bank financing of municipal borrowing.
Municipal Finance Policy	Yes.	Yes. Various aspects.
Demand Side—Bondholders	Bank role in marketing and lending to municipalities.	Technical assistance to banks.
Capital Market Interventions	None.	Created MUFIS.
Supply Side—Bond Issuers	Capital finance training and technical assistance to municipalities.	Training and project preparation assistance.
Financial Resources	No loans from USAID in connection with these projects.	\$34 million Housing Guarantee loan.
Results	Evolution from GKO to Communal Service Bonds (longer term), including Eurobonds.	\$900 million municipal sector loans (1993-96). \$180 million in bonds (excluding Prague).

Appendix A, continued

	South Africa	Zimbabwe
Project Name	Municipal Environmental Development Program	Private Sector Housing Program
Macroeconomic Policy	None.	None.
Capital Markets Policy	Limited.	Limited technical advice.
Municipal Finance Policy	Housing and municipal finance policy. Focus on credit enhancement.	Municipal infrastructure finance assessment. Promoting transition from prescribed assets.
Demand Side—Bondholders	Assistance on reorganization of outstanding bond portfolio.	Informal.
Capital Market Interventions	Assistance to Intermediary, INCA.	Prior assistance to building societies.
Supply Side—Bond Issuers	MIU for project development within Development Bank of South Africa.	Public/private symposium planned.
Financial Resources	\$5 million Housing Guarantee to INCA.	Prior Housing Guarantee loans have supported housing finance.
Results	INCA: R512 million in loans as of June 1997.	Expanded interest of private sector and government.

Part II

Country Case Studies

Czech Republic
Indonesia
Philippines
Poland
Russia
South Africa
Zimbabwe

Czech Republic: Quick Start Toward a Competitive Municipal Credit Market¹

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1.1 Introduction

The Czech Context

After the fall of Communism, the Czech Republic (until January 1993 part of Czechoslovakia) reorganized its economy and government in decentralized form. Fundamental service responsibilities, including responsibility for administering elementary and secondary education, most health care, and the vast stock of public housing, were transferred to local governments. Citizens reacted against the previously centralized power of the State by subdividing even small towns into new local jurisdictions. By 1995, there were more than 6,200 separate municipalities in a country with a total population of only 10.2 million. Some 2,000 of these towns had been created since the collapse of Communism.

The Czech Republic developed its own form of fiscal support for this government structure. Funds to pay for schooling and health care were transferred to local authorities from the State, through standard payments per pupil or per patient, adjusted for certain cost factors. These were regarded as fundamental service obligations that local governments carried out on behalf of the State. Other local services were financed principally by formula-based revenue sharing or by state grants to local governments. Most of the recurring revenues of local governments came from their share of the income tax (and later, self-employment tax) collected by the State. Initially, most capital investment was financed by State grants.

In contrast to the experience of many other Central and Eastern European countries, where the local allocations of shared taxes were cut drastically because of the State's budget difficulties, local governments in the Czech Republic benefited from a relatively stable tax-sharing formula, tied to a buoyant tax base. For the first several years of the new fiscal regime, the revenues that local governments received from shared taxes rose faster than total State tax collections—due primarily to the importance of the rapidly growing income tax in their revenue mix.

Local government budgets in the Czech Republic can be characterized by four main distinguishing characteristics:

1. Until 1997, local revenue growth substantially outpaced inflation, leading to significant growth in real revenues at local authorities' disposal.

¹ This chapter draws heavily on George Peterson et al., *Monitoring Report: Municipal Infrastructure Financing Program, Czech Republic* (Washington, DC: Urban Institute, June 1997).

2. Local budgets have been managed conservatively. Every year through 1996, the local government sector had aggregate surpluses. Few local authorities have fallen into serious financial difficulty.
3. Local governments finance unusually large levels of investment. Local authorities in the Czech Republic carry out the bulk of public sector investment. The share of local spending devoted to capital formation is exceptionally high by world and regional standards—38.8 percent in 1995. This investment has been financed both from central government transfers and from very substantial operating budget surpluses that local governments have been able to accumulate.
4. Local governments, however, have very little control over their own revenue bases. Not only do 90 percent of their revenues come from the central government, in the form of shared taxes or grants, but also the only “local” tax, the property tax, is subject to a country-wide rate schedule applied to property values assigned by central authorities; property taxes are collected by the district arms of the central government. The only true discretionary revenue source at the local level is fees and charges for specific services. Even then, some of the most important services, such as water supply and district heating, have been subject to centrally imposed price controls.

The Financial Sector

Relative to most of Central and Eastern Europe, the Czech Republic has a highly developed banking sector. Commercial bank lending, at more than 60 percent of gross domestic product (GDP), is by far the highest in the region. Czech banks were partially privatized at an early stage. However, the State retained a significant ownership share in each of the largest banks, and has implemented financial sector policy through the banks.

The banking structure has emerged as one of the trouble points in Czech economic development. Following the German model, banks were significant owners of industrial corporations and other businesses. Their control over the corporate sector increased during Czech voucher privatization. A majority of the voucher shares in privatized companies ended up in the hands of investment funds, most of which were controlled by the banks. This linkage among banks, their investment funds, and companies slowed the process of corporate restructuring. The banks viewed companies primarily as borrowers, and failed to exert shareholder pressure for restructuring management. This arrangement led banks to favor work-outs of corporate bad debts in cooperation with existing management, rather than the drastic restructuring of companies that made private industry more competitive in Poland and Hungary.

Deregulation of banking in the Czech Republic led to an unusual banking structure. A large number of new banks were created, many of them thinly capitalized. Before the requirements for establishing new banks were tightened, 61 banks had been licensed. However, the overwhelming majority of business was transacted by the three large banks carved out of the previous State Bank and still under partial State control. Each of these banks initially had quasi-monopolistic control over the portion of the financial sector in which it specialized—for example, retail savings deposits in the Savings Bank and international trade in the Bank of International Commerce.

1.2 Objectives for the Municipal Credit System

The Czech government viewed development of a municipal credit system as important for two reasons. First, it would allow the central government to substitute credit financing for State grants in support of local capital investment. Use of municipal credit in this way would both relieve pressure on the State budget and support decentralization by reducing State control over local investment choices. Second, market-based lending to municipalities should increase the efficiency of local investment by making clear the true cost of capital. State capital grants, like subsidized loans from State agencies, reduced the apparent cost of capital, encouraging local governments to invest inefficiently. It was hoped that development of a municipal credit system would allow local authorities to sustain or even increase their high levels of investment, while decreasing central government capital subsidies.

The government did not intend to abandon grant assistance for capital projects altogether. Rather, State capital grants and below-market loans would become targeted on specific types of investments, such as local environmental projects, that had significant externalities and deserved subsidy. The rest of municipal investment would be made to fit within a market framework.

1.3 Competitive Municipal Credit Market or Monopoly Lender?

One of the first choices confronted in municipal credit market design was the choice between a sheltered, specialized, and monopolistic municipal lending authority and an open, competitive municipal credit market. At one point, the government introduced in Parliament a bill that would have given the Czech Savings Bank monopoly lending powers in the municipal sector. The municipal lending wing of the Savings Bank would have acted as a Municipal Bank in the Western European tradition, protected by law from other financial-sector competition, just like the municipal banks in France, Spain, or the Netherlands were in their formative stages.²

The alternative view—espoused by USAID—held that Czech municipalities would benefit from competition in municipal lending. It maintained that competition among municipal lenders would drive down interest rates, extend the maturity of municipal loans, and move municipal lending away from exclusive reliance on real property as collateral. Competition was to be encouraged not just among Czech banking institutions, but also between bank loans and municipal bonds, and between domestic lending and international lending.

Support for a competitive municipal credit market was not premised on across-the-board ideological preference. State-endorsed municipal banks or municipal development funds have a role to play when municipalities are just beginning to venture into significant investment projects. Parastatal lenders can work with municipal borrowers to develop sound investment projects and can become their partners in deciding how to use credit prudently to finance these investments. Czech municipalities, however, were further along. They already were carrying out large volumes of investment and had demonstrated the ability to handle the technical aspects of project design on their own. Moreover, Czech local governments managed their finances conservatively. The sector as a whole maintained large operating surpluses. These surpluses, if

² The proposal to create a monopolistic municipal lending authority within the Savings Bank was proposed by a consultant group from Credit Local de France, the specialized municipal bank of France.

used for debt servicing, could support a higher level of self-financed investment, and help meet the massive backlog of local infrastructure needs.

In these circumstances, it was judged that Czech municipalities did not need the hand-holding of a specialized financial intermediary. Rather, the creation of a monopolistic, state-protected municipal bank would introduce political factors into municipal lending and retard the development of a true municipal credit market where local authorities have independent access to investment funds. After fairly extensive dialogue, the Czech government also decided that a competitive credit market would best serve the needs of Czech municipalities.

1.4 The Strategy and Tools of Market Development

To help build a municipal credit market, USAID pursued several lines of action simultaneously, as discussed below.

Technical Assistance to Banks

One of the first challenges was to familiarize Czech banks with municipal lending and municipal credit analysis. When the technical assistance effort began, in 1992, banks made only short-term bridge loans to municipalities. The longest term municipal loan in the country was for four years. Moreover, banks evaluated municipal credit applications in the same way they evaluated loan applications from commercial firms. The financial information forms that municipalities had to fill out were exactly the same ones required of commercial borrowers, even though a majority of the queries had no meaning at all in the context of municipal budgets. When they did make loans to municipal governments, banks required physical collateral in the form of municipal-owned property of much greater value than the amount of the loan. Banks did not understand the finances or budget management of local governments, but viewed municipalities as high-risk borrowers.

Seminars in municipal credit analysis were offered through USAID to all of the principal banks. The basic seminars were conducted jointly. Thirteen banks, including the six largest banks, participated in three 2½-day seminars, which explored municipal financial accounting, the sources of municipal credit risk, and analytical methods for quantifying risk, as well as the legal regulations surrounding foreclosure on municipally owned property or municipal failure to make timely debt payments. These seminars also introduced the idea of revenue or project finance, where loans are secured primarily by project income rather than real property collateral. One credit analysis seminar was held jointly with municipal finance officers from larger towns in the Czech Republic, so that both sides could share their perceptions of credit risk and how to calculate a town's prudent borrowing capacity. The goal of the training seminars was to make banks confident that they could assess municipal credit risk and respond promptly to municipal loan applications.

Following the basic seminars, conducted jointly for participating banks, USAID and its consultants offered follow-up specialized training tailored to the needs of individual banks. Five banks took advantage of this offer. The training typically was oriented to a bank's branch managers, scattered around the country, who handled applications for small- to medium-scale municipal loans at the local level. The consulting team also assisted individual banks in preparing their credit assessment manuals, which spelled out the methodologies that were to be used in appraising municipal loan applications.

Technical Assistance to Municipalities

At the same time that technical assistance was being provided to banks, another group of consultants was working with municipalities, and with the Czech Association of Towns and Cities, on budget preparation, the towns' own calculations of their borrowing capacity, and preparation of loan applications. The municipal consultation was conducted separately from the bank consultation, using different advisors and, with the exception of one joint seminar, separate agendas. The rationale for this separation was to encourage arm's-length dealings between municipal loan applicants and bank lenders. It was felt that if the same technical advisors worked with both parties, there would be a temptation, just as in a monopolistic municipal development fund, to bring the two parties together in a "deal." However much this intervention might accelerate the closing of an individual loan, it would not prepare either side for continuing arm's-length negotiations in the future.

Out of the technical assistance to municipalities came a computer model that could be used for budget analysis and calculation of local borrowing capacity. The model was endorsed by the Association of Towns and Cities and spread widely throughout the municipal sector. Annual meetings of local municipal finance officers were convened, starting in 1996. More than 500 local budget officers attended each of the first two annual meetings in Prague, where a variety of specialized topics in financial management were debated. These ranged from setting up short-term investment pools that could improve municipalities' earnings from cash holdings to the changes in municipal accounting and auditing standards that would be required by accession to the European Union.

Public Policy and the Credit Market

A third strand of work has taken place at the national level. Part of this effort involves the dissemination of information as to how the municipal credit market is working. For example, by the end of 1996, banks had made approximately 2,000 municipal bank loans to more than 1,000 municipalities, without a single case of default. The Czech Savings Bank, the largest municipal lender, reported a problem loan rate of less than 1 percent in the municipal sector. This compares with problem loan rates in the commercial-industrial sector in excess of 20 percent. As a result of this favorable lending experience, the Czech National Bank (the central bank authority) has classified the municipal sector as the second least risky category of lending after lending to the national government. The sector carries a BIS (Bank of International Settlement) risk weighting of only 20 percent over lending to the national government. Rapid dissemination of the track record of municipal borrowing has led to a reassessment of credit risk in municipal loans and to a decline in municipal interest rates relative to the rest of the credit market.

Growth of the municipal bond market likewise has been encouraged. Under the auspices of the USAID-Czech Government Program, representatives of international credit agencies such as Standard & Poor's and Moody's were brought to meetings of the Association of Towns and Cities to explain their credit rating procedures in support of bond issues. The program collaborated with financial officers of larger cities in organizing financial information for presentation in bond prospectuses and in evaluating prospective underwriters.

Finally, the program has supported development of a coherent national policy framework for the municipal credit market. Guidelines have been prepared for municipal financial disclosure, and discussed both with the Association of Towns and Cities for voluntary adoption and with the

government as potential mandatory standards. Current accounting and auditing procedures have been analyzed, with recommendations for improvements that would both serve the interests of the municipal credit market and prepare the Czech Republic for entry into the European Union. Finally, the national government and Parliament are currently debating the advisability of imposing debt ceilings on local governments. The program has assembled information on the types of debt limits or oversight of municipal borrowing employed elsewhere in the world, and sponsored trips for Ministry of Finance officials to state commissions in the United States that have this kind of regulatory responsibility.

The Municipal Infrastructure Financing Company (MUFIS)

USAID has supported the creation of a financial intermediary for municipal lending: the Municipal Infrastructure Financing Company, or MUFIS. This company has borrowed funds from the U.S. market, under USAID auspices and using a U.S. Government guarantee, then on-lent the funds to participating banks for long-term lending to finance municipal infrastructure investment. MUFIS was designed to stimulate development of the overall municipal credit market. Consistent with the objective of promoting competition within the banking sector, MUFIS funds were made available to any bank meeting its credit standards.

Twelve banks have entered into contractual arrangements with MUFIS. Six of these banks have actually borrowed funds from MUFIS to date, and used them to finance long-term municipal loans. Under the terms of the line of credit, the borrowing banks assume all of the credit risk associated with their municipal loans. The banks' borrowing must be repaid to MUFIS regardless of whether the banks themselves are repaid by the municipalities.

MUFIS' main purpose is to demonstrate in practical terms to banks that long-term lending to municipalities is prudent and profitable. The loans financed by MUFIS are for 7 to 15 years, inviting banks to stretch their normal loan practice. MUFIS also has provided a laboratory for applying other principles covered in the bank technical assistance program. For example, MUFIS-financed loans were among the first to relax requirements for real property collateral in favor of stronger identification of specific revenue streams that would be used for loan repayment.

MUFIS is also authorized to participate in the underwriting of municipal bonds. It may purchase up to 20 percent of an original bond issue, on the same terms available to the private institutions that purchase the remaining 80 percent of the bond issue.

The MUFIS program has introduced several Czech banks to the municipal sector and municipal lending. It removes liquidity risk as a factor in banks' calculations about entry into the sector. In return, the program limits banks' margins. Loans to banks under the program have been made at 9.5 percent, with a maximum 2.5 percent margin, resulting in a ceiling rate for bank lending to municipalities of 12.0 percent. These figures compare with an average inflation rate over the period of program operation of slightly more than 9 percent.

1.5 Policy Agreement

The USAID-Czech Government strategy is marked by a Policy Agreement that states the objectives of the municipal infrastructure financing program and identifies specific benchmarks that will be used to measure the success of the program. The Agreement was designed to

reinforce the understanding that MUFIS and the technical assistance program were not ends in themselves, and that it was not sufficient for program success that MUFIS prosper as an institution or that participants give high ratings to the technical assistance they received. The *policy* objectives behind the program are much broader. They involve creation of a self-sustaining municipal credit market, which is used to sustain local government investment in the face of cutbacks in State capital grants. The MUFIS and technical assistance program are tools in this process.

The Policy Agreement states that:

- MUFIS itself shall demonstrate that properly designed municipal lending involves acceptable credit and business risks, by disbursing its funds through the commercial banking system, receiving 100 percent timely loan repayments on all of its loans to participating banks, and achieving a problem loan rate for loans from banks to municipalities of no more than 5 percent (as measured by loans where payments are 30 days or more past due).
- Private-market, commercial lending to municipalities in the aggregate shall increase at least 10 percent per annum in real terms from the 1993 baseline and shall increase faster than State subsidies for local investment.
- Total municipal capital investment shall increase by 10 percent per annum in real terms from the 1993 baseline, thereby demonstrating that investment levels can be sustained and continue to grow despite restraint in central government subsidies.
- Competition in the municipal credit shall grow, as measured by the number of banks lending to local governments, the availability of municipal bonds as well as commercial bank loans as credit sources, and the development of access by larger cities to both domestic and international credit markets.
- The terms of municipal loans shall become more favorable over time as measured by municipal interest rates in the commercial market relative to other interest rates, and by a lengthening of average loan maturity.

The Policy Agreement specifies that progress toward the policy objectives and the benchmarks spelled out in the Agreement will be monitored annually. Problem areas will be identified for the partners to the Agreement to address.

1.6 Accomplishments

Most of the objectives of the Policy Agreement have been met with ample room to spare. In fact, the Czech municipal credit market has gotten off to one of the fastest starts on record, and has done so within a competitive framework.

In the area of commercial lending, private-sector bank loans to municipalities, as shown in Table 1.1, grew by more than 350 percent between 1993 and 1996.³ Of particular interest for infrastructure financing, however, is the growth of long-term lending. The Czech National Bank defines “long-term” loans as loans of four-year maturity or greater, “medium-term” loans as loans of one to three years, and “short-term” loans as loans shorter than one year. Long-term municipal loans outstanding at the end of 1996 were almost 12 times the level reached at the end of 1993.

The aggregate shift in the structure of municipal commercial debt from short and intermediate term to long term has been striking. The share of long-term loans in total borrowing from commercial banks’ debt was nearly 70 percent at the end of 1996. The lengthening of loan maturity provides a more stable basis for infrastructure financing and alleviates the threat of a financing crisis resulting from municipalities’ inability to roll over short-term debt. Unfortunately, no data are available regarding the total volume of loans of seven or ten years’ maturity or longer, which would be considered long-term in the United States or Western Europe.

Table 1.1 Volume and Term Structure of Municipal Commercial Credit Outstanding

Type of Credit	December 31, 1993		December 31, 1994		December 31, 1995		December 31, 1996	
	K (000)	%	K (000)	%	K (000)	%	K (000)	%
Short term ^a	632,960	31.8	769,244	18.2	1,802,455	24.6	525,541	5.8
Medium term ^b	818,761	41.3	1,663,129	39.4	1,916,579	26.1	2,331,599	25.4
Long term ^c	532,661	26.9	1,790,081	42.4	3,611,176	49.3	6,309,794	68.8
Total	1,983,382	100.0	4,222,454	100.0	7,330,210	100.0	9,166,934	100.0

^aLess than one year.

^bOne to three years.

^cFour years or more.

The aggregate shift from short-term to long-term credits has been accompanied by a lowering of interest rates in the municipal sector. Municipal rates have fallen faster than other interest rates in the economy, as it became clear that municipal lending was a relatively low-risk activity.

Favorable experience with commercial loans encouraged both municipalities and financial sector institutions to develop direct access to the capital market through bond issues. Table 1.2 shows the growth of municipal bond issuance. Although comparisons are easily distorted by the city of Prague’s \$250 million bond issue sold to the Euro market in 1993, the general trend of bond issuance is strongly upward. By 1996, all cities with populations over 150,000 had issued municipal bonds. A partial segmentation of the credit market had developed. The majority of towns found it cheaper and more efficient to access commercial credit through the banking

³ The data reported in all of these tables are unadjusted for inflation. The inflation rate over the period averaged slightly more than 9 percent per year. The exchange rate for the Czech koruna fluctuated between 25.5 and 29.0 to the dollar, its value rising during the first part of the period and declining toward the end of the period.

system. However, the largest cities, which issued bonds of larger magnitude, found the costs of bond preparation and issuance to be outweighed by interest-rate savings. In addition, some smaller cities issued municipal bonds as a way of benchmarking their costs of capital when dealing with commercial banks.

Two Czech cities, Prague and Ostrava, received international bond ratings from Standard & Poor's, and sold their bonds in the international market. Both cities were rated single-A at the time of issuance. Prague's debt was subsequently upgraded further by Standard & Poor's.

Table 1.2 Municipal Bonds Issued in the Years 1992-1996 (in million K)

	1992	1993	1994	1995	1996	1992-1996
Number	1	1	8	3	5	18
Total Amount	8.5	20.0	7,869.3	660.0	3,368.2	11,926.0
Total Amount Excluding Prague	8.5	20.0	575.0	660.0	3,368.2 ^a	4,631.7

^aIncluding the second tranche of Pilsen (Plzeň) Bonds (200 million K), which was approved in 1995.

1.7 Municipal Investment Levels

Did the growth of private-market lending substitute for State capital grants, as had been planned? Were municipalities able to sustain real investment levels, while making the transition from State subsidy to market-rate borrowing?

Table 1.3 summarizes the record of municipal infrastructure investment and the sources of financing for this investment. It shows that total municipal investment grew rapidly from 1993 to 1995, before slowing its growth in 1996.

Over the three-year period, the share of municipal capital investment financed by State grants fell by almost half, from 49.7 percent to 25.5 percent. Part of the capital financing gap has been filled by commercial credit. However, municipalities also have used their own resources (i.e., their operating budget surpluses) to pay for a large part of their investment. There also has been growth in subsidized lending from the State Environmental Fund, which now makes interest-free loans to municipalities for targeted investment projects. These loans are shown as "zero-interest debt" in the table.

Table 1.3 Municipal Infrastructure Financing

	1993		1994		1995		1996	
	K (bill.)	%	K (bill.)	%	K (bill.)	%	K (bill.)	%
Investment Expenditure	31.6	100.0	42.4	100.0	50.9	100.0	53.4	100.0
Financing Sources: Capital Subsidies	15.7	49.7	14.3	33.7	19.1	37.5	13.6	25.5
Commercial Debt	2.1	6.7	5.5	13.0	9.2	18.1	9.1	17.0
Zero-Interest Debt	0.4	2.5	1.2	5.0	2.9	5.7	2.7	5.1
Own Resources	13.4	41.1	21.4	48.3	19.7	38.7	28.0	52.4

How much did MUFIS, the municipal financing intermediary established with USAID assistance, contribute to evolution of the municipal credit market?

MUFIS never has accounted for more than a moderate share of the total commercial bank credit market. At its peak level of activity in 1995, MUFIS financing represented about 15 percent of the net increase in municipal loans. However, it counted for a larger share of the market it was designed to develop, long-term lending. Bank loans financed by MUFIS accounted for about 25 percent of net “long-term” lending (four years maturity or longer) in 1995, and a much higher, but unknown, proportion of lending of ten years or longer. MUFIS-sponsored loans also helped increase competition in municipal lending. In 1995, they financed two-thirds to three-fourths of all long-term bank lending by other than the Czech Savings Bank, the dominant lender in the field.

After 1995, as the commercial credit market continued to grow, and banks found it attractive to finance municipal loans from their own deposits and other resources, MUFIS’ share of the municipal credit market declined. It did, however, continue to introduce new banks to municipal lending.

1.8 Outstanding Issues

The USAID program appears to have delivered on its initial objectives of stimulating a competitive municipal credit market that could be sustained without foreign intervention or government subsidy. Nonetheless, as the program matures, it and the Czech credit market face a new set of challenges.

When Should MUFIS Exit?

In principle, MUFIS was designed to be a transitional institution that would disappear once its mission of helping to establish a municipal credit market had been accomplished. Like many institutions, however, MUFIS has not voluntarily embraced this future. MUFIS has sought to extend its existence, either on its own or by being absorbed by one of its co-owners, the Czech and Moravian Guaranty and Development Bank. Its managers have sought access to State

subsidy funds to allow it to specialize in certain parts of the market, such as lending to very small municipalities. Whether MUFIS will allow itself to be “sunset” remains to be seen. If it continues in operation, at some point it may become a subsidized competitor of private financial institutions rather than a vehicle for developing private sector capacity.

How Should Small Municipalities’ Capital Needs Be Financed?

The issue of how to finance small municipalities’ capital investment is a legitimate one. It is more acute in the Czech Republic than elsewhere. Well over half of all municipalities in the Czech Republic have populations of less than 2,500. They are not big enough to access the capital market on their own and often are not big enough to justify lending from one of the commercial banks. Various approaches to meeting their financing needs have been debated. In one option, the equivalent of a small-municipalities bond bank or small municipalities’ loan fund could be established, with the institution raising funds on the domestic capital market and on-lending to small towns for infrastructure financing. This arrangement is not unlike that used by MUFIS at present, except that it would be financed through domestic bond issues. The system, however, would require some kind of subsidy to be viable. It also skirts the question of whether small municipalities of this kind *should* be financing investment projects on their own. For many projects, infrastructure built on this scale is technologically inefficient. The creation of a subsidized loan fund may merely perpetuate these inefficiencies.

Deterioration of the Czech Economy

The rapid development of the municipal credit market in the Czech Republic owes much to the budget strength of local governments. The strong financial position of local authorities has made them creditworthy. Critical to the strength and stability of local budgets has been the system of intergovernmental tax sharing. The State budget, in turn, has been able to generate revenues for local government because of the relative strength of the Czech economy. In 1997, however, economic conditions in the Czech Republic suddenly deteriorated. Growth slowed, the State budget came under pressure, and, for the first time, significant cutbacks in local government revenue allocations occurred. This experience promises to test the Czech local government financing system, including the municipal credit market. It highlights the dependence of local governments on State revenue sources. Local governments have very limited flexibility for raising additional revenues at the local level through local actions. The continued creditworthiness of Czech municipalities, and the viability of the municipal credit market, therefore rests on the system’s ability to maintain broadly stable and predictable intergovernmental revenue flows. Over the intermediate term, the current situation argues strongly for decentralizing to local governments more control over the revenue side of their budgets to accompany the significant decentralization of expenditures that already has taken place.

2

Indonesia: Implementing the Municipal Revenue Bond Program

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2.1 Introduction

The Government of Indonesia (GOI) has embarked on a carefully planned effort to test the viability of a municipal bond market in Indonesia. The GOI has initiated a pilot program to “learn by doing” in working with a small group of local water authorities to issue revenue-backed bonds on the private capital market in Indonesia.

This pilot program is still under way; several bond issues are on the point of being issued, although none has yet come to market. The results of the effort to date are promising. There is considerable demand for credit on the part of local governments and public enterprises and there is a pool of borrowers with proven management and bankable projects. At the same time, there are a number of obstacles to full utilization of bonds that have emerged and must be dealt with by the Government. The most important of these is competition from subsidized credit and interference by different interest groups that distort the investment and financing decisions.

The importance of the pilot program has been underscored by recent events in the international currency markets that have driven down the value of the Indonesian Rupiah and dramatically raised the cost of Indonesia’s offshore debt. Indonesia needs to become more reliant on its own domestic capital markets to finance infrastructure investment, and municipal bonds are one instrument, among several, for accomplishing that goal. This case study describes the pilot program in Indonesia and the lessons learned in this still-young effort.

2.2 USAID's Role in Indonesia's Municipal Bond Market Activities

USAID has provided resources for a wide range of municipal finance activities in Indonesia, including the development of the municipal bond market, as part of its work to improve urban environmental management in Indonesia. In particular, USAID has worked with the GOI, local governments, and nongovernmental organizations (NGOs) to encourage:

- the adoption of new policies and practices to facilitate decentralized financing of urban services;
- wider adoption of improved practices in urban environmental infrastructure provision (including privatization);
- adoption by government and industry of policies and procedures to reduce industrial damage in the environment and to promote cost-effective use of clean, renewable energy; and
- greater participation by community residents in decisions regarding urban environmental infrastructure.

USAID has committed significant resources for these purposes over the past decade in the form of both grants and loans. Many of the policy decisions related to municipal bonds discussed in this paper have been supported with technical advice under the Municipal Finance Project (MFP). MFP has provided long-term technical advisors to the Ministries of Finance, Home Affairs, and Public Works, as well as the National Planning Agency (BAPPENAS).

USAID's resources augment extensive expenditures for (1) urban activities being carried out by the central government, (2) grant and loan funds being made available by the central government to local governments through a range of programs and public financial intermediaries, and (3) funds from multilateral organizations working on urban environmental issues in Indonesia, including the Asian Development Bank (ADB), the World Bank, and the United Nations Development Programme.

2.3 National Policy Context for Activities to Develop the Municipal Bond Market¹

Since 1987 (beginning of the fifth National Five-Year Development Plan, or *Repelita V*), a basic tenet of the GOI's Urban Policy Action Plan has been that local governments should be given increased authority and technical competence to generate revenues and improve their credit-worthiness and debt-carrying capacity. Simultaneously, long-term debt financing should be made more available to creditworthy municipalities and municipal enterprises so that they can make investments now and pay for them as they are used. This "pay as you use" policy is common in most developed and in numerous developing countries. For example, in the United States, such subnational debt-financed investment in infrastructure and services amounts to about \$5,000 per person, financed primarily by bonds. In Europe, the levels of debt-financed investment are comparable, but the investment is financed primarily with loans from municipal development banks. In Indonesia, such debt financing remains underused.

In Indonesia, long-term debt financing was initially made more available to local governments for urban infrastructure primarily through bilateral and multilateral foreign loan programs (International Bank for Reconstruction and Development [IBRD], ADB, USAID, etc.) and through the Regional Development Account (RDA) of the Ministry of Finance. The foreign-donor loans have generally been channeled through targeted infrastructure projects that provide the funds to local governments and local public enterprises as "subsidiary loan agreements" (SLAs) between the central government and the local borrowers. The SLAs have typically entailed a great deal of involvement by the central government ministries and outside consultants. In contrast, the RDA loans are designed to respond to borrower initiative, are smaller in size, and are tailored to the needs of the individual borrowers.

These programs have traditionally offered loans to local governments at subsidized rates (currently 11.5 percent for SLA and RDA loans, denominated in Rupiah). These rates were

¹ Information for this section is adapted largely from a report coauthored by Rusmana Ardiwinata, SH, Director, Directorate for Local Government Revenue, Directorate General for Public Administration and Local Autonomy, Ministry of Home Affairs; and William Kugler, Policy Advisor, Ministry of Home Affairs, titled *Overview of the Revenue Bonds Implementation Program* (Research Triangle Park, NC: Research Triangle Institute, March 1997).

intended to be gradually increased to approach commercial rates as municipal demand for debt financing increased, in order to ultimately stimulate the mobilization of domestic resources for municipal lending. While these programs administered by the central government have been extremely important to the development of Indonesia, they have also presented various negative characteristics from the perspective of local government borrowers and have restricted the ability of this mechanism to grow as rapidly as hoped. Typical problems have included excessively long planning and approval cycles, inflexible and/or inappropriate project design and implementation standards, insufficiency of funds available, and untimely disbursements. Due to the continuing subsidized interest rates and public institutional form of these programs, they have not been able to mobilize long-term domestic funds for municipal infrastructure investments.

Despite these criticisms by local governments, these programs were essentially the “only show in town” as far as available sources of long-term debt financing. However, with the increasing availability of long-term funds in the domestic capital markets, the GOI believes that there is now a realistic opportunity to introduce municipal bonds as a new alternative mechanism for mobilizing funds for infrastructure investment, starting with revenue bonds of local water authorities, the *perusahaan daerah air minum (PDAM)*. This window of opportunity has been made possible by concurrent development of a Government policy-level consensus to proceed, development of the domestic capital market, and development of local government management and finance capabilities, as described below.

Government Policy-Level Learning and Consensus

The GOI has had a longstanding commitment to increase the use of domestic capital for urban infrastructure investment, including both equity and debt mobilization. However, until recently the GOI focus has been primarily on developing the local governments’ ability to manage debt—via the “soft-loan” programs of the RDA and SLAs—rather than on providing access directly to the capital markets. Debt utilization by local governments and enterprises has increased markedly since the late 1980s to the point where demand for RDA loans has outstripped available capital and the GOI is now exploring the alternatives for turning the RDA into a true financial intermediary. Furthermore, as noted previously, recent events in the international currency markets have made clear that Indonesia cannot remain so heavily dependent on international capital flows for financing its public and private sector investments.

Starting in mid-1993, the GOI has been continuously researching and discussing at the policy level the pros and cons and the underlying feasibility of development of a municipal bond market in Indonesia. These discussions have actively involved:

- regulators: the National Securities and Exchange Board (BAPEPAM), the Ministry of Finance, the Ministry of Home Affairs, and BAPPENAS;
- potential issuers (including municipalities and their enterprises; especially PDAMs);
- potential investors (including insurance companies, pension funds, investment funds, mutual funds);
- supporting institutions (the Securities Rating Agency [PEFINDO], underwriters, legal advisors, public accountants, trustees/paying agents, etc); and
- members of the donor community working in the municipal sector, particularly USAID, IBRD, and ADB.

The consensus-building has been largely an educational process that has allowed participants to learn about fundamental conditions needed for a municipal bond market, to observe experiences of other countries, and to frankly exchange views and concerns regarding the appropriateness of municipal bonds in the Indonesian environment. In 1994, the "Policy Action Plan for Local Government Bonds" was issued, documenting the approach the government intended to follow.

While developing an appreciation of the basic "technical" requirements for market development (e.g., interested issuers, interested investors, appropriate regulatory bases, rating agency, etc.) was fairly straightforward, the underlying issue requiring a policy-level consensus was "to what extent could local governments be allowed to incur long-term debts through mechanisms not under the direct control of central authorities."

Given the current experience in several developing and transitional economies, where a "wild West" atmosphere prevails in the new bond markets, this reluctance was warranted. However, with (1) the creation of PEFINDO and BAPEPAM's new requirements for rating of all publicly offered bonds, (2) the growing sophistication of the investor community, and (3) the improvements made in monitoring and supervision by the Ministry of Finance and Ministry of Home Affairs, there has evolved within the GOI a consensus that if issuers and investors support it, development of this market should be encouraged.

Capital Markets Development

The capital markets are developing rapidly and substantial long-term funds are becoming increasingly available for domestic investment. As noted above, the improved BAPEPAM regulations and the establishment of PEFINDO are a huge contribution to making a municipal bond market feasible, from the perspective of both the government and potential investors who are not yet familiar with municipal bonds. The recent positive track record with bonds and commercial paper for both commercial and state enterprises (especially for toll-road bonds and bonds of the Regional Development Banks) have built investor familiarity and confidence in new and longer-term investment instruments. The concept of investing in medium- to long-term bonds offered by nonsovereign government institutions is no longer such a wild leap of faith for essentially conservative institutional investors such as insurance companies and pension funds.

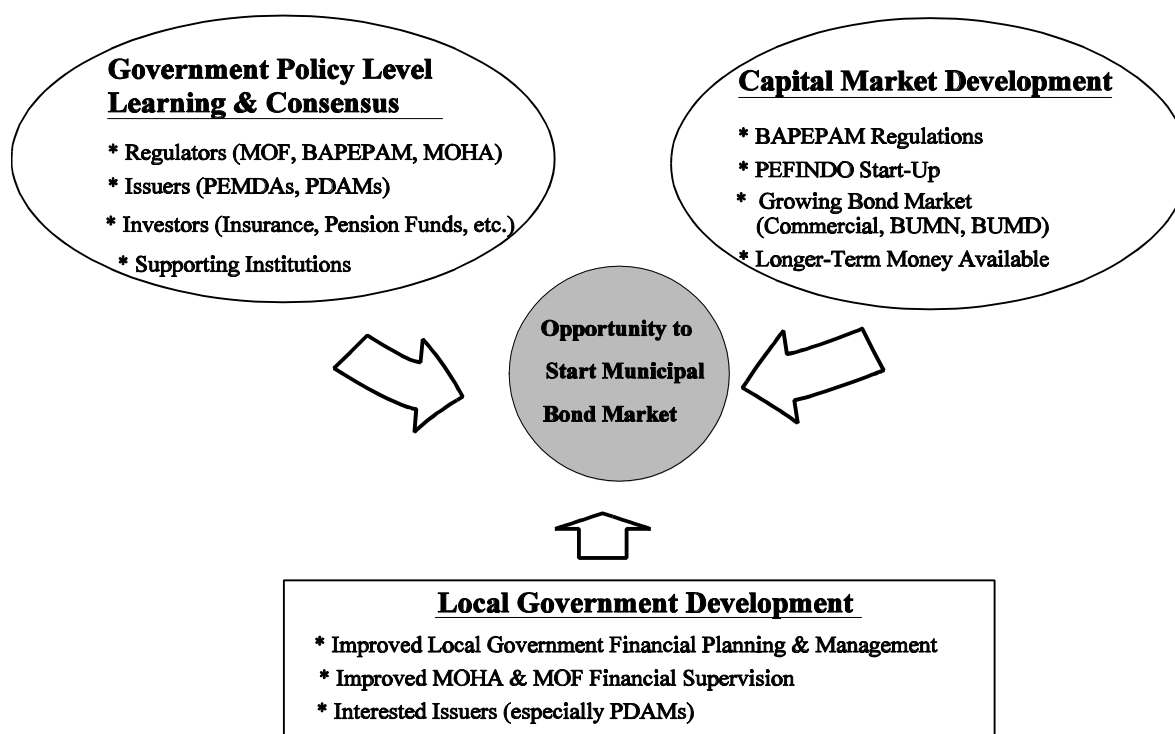
Local Government Development

The overall financial planning and management capabilities of local governments and their enterprises have improved markedly over the past few years. While the improvement is, of course, uneven, we can say that some local governments and municipal enterprises are now managed very professionally. MOF and MOHA have both dramatically improved their abilities to monitor and evaluate the technical and financial performance of local governments and enterprises and can make a useful contribution toward identifying and encouraging the best potential issuers while discouraging others.

Local governments and their enterprises (especially PDAMs) have improved their project preparation capabilities and have a large number of bankable projects that is far larger than the funds available through the traditional subsidized financing sources. Local governments and their enterprises are also becoming increasingly aware of the potential advantages of financing through the bond market in order to drastically reduce bureaucracy and the excessively long and complicated approval cycles.

These complimentary developments lead the GOI to believe that the time is now appropriate for initial implementation of the municipal bond market. Figure 2.1 illustrates the range of factors that contributed to this situation.

Figure 2.1 1993-1997 Developments Regarding the Bond Market



Legend:

BAPEPAM	=	National Securities and Exchange Board
BUMD	=	local government enterprise
BUMN	=	national government enterprise
MOF	=	Ministry of Finance
MOHA	=	Ministry of Home Affairs
PDAM	=	<i>perusahaan daerah air minum</i> (local water authority)
PEFINDO	=	Securities Rating Agency
PEMDA	=	local government

2.4 Bond Market Implementation Strategy

The key to building the market was seen as building upon success. Therefore, the program was designed to work with the most creditworthy borrowers and to start by implementing bond issues that have the highest potential for success.

From the investors' perspective, the two absolutely crucial ingredients of any bond issue are:

- a solid legal basis — that is, the issuing entity itself is legally grounded and the issue represents a legal obligation; and

- an adequate and predictable revenue stream to pay the bond interest and principal.

Therefore, the options of issuing either general obligations of local governments or revenue bonds of local public enterprises (both options are examined in the subsections that follow) were evaluated from the perspective of these key investor needs.

Option 1: General Obligations of Local Governments (PEMDAs)

Local governments have clear legal status to borrow, but revenue streams are not clear to investors. Because PEMDAs typically rely upon central government grant funding for 70 percent or more of total revenues, their revenue streams cannot be regarded as predictable or necessarily adequate. There also exists a high risk of additional tasks being transferred to local governments without adequate sources of funds being provided at the same time (unfunded or underfunded mandates).

Investors accustomed to investing in commercial enterprises, frankly, do not understand PEMDA management and finance. In particular, the accounting systems of PEMDAs are still set up on a cash-accounting basis, which does not provide adequate financial performance data to investors. This lack of understanding poses unacceptable risks to them.

Therefore, under current conditions, general obligations of PEMDAs do not appear to be feasible.

Option 2: Revenue Bonds of BUMDs (Especially PDAMs)

These revenue bonds appear to meet the basic investor requirements and, for a number of reasons, have clear advantages as first entrants to the municipal bond market.

First, PDAMs have clear legal authority and provide an essential service that forms the basis of steady, predictable income streams. The structure of PDAM tasks, management, and finance are compatible with normal commercial practices, so investors and other market participants can easily understand them.

PDAMs also use standard commercial accounting systems, which can provide adequate financial performance data to investors in easily understood formats. Many also have documented histories of good technical and financial management and creditworthiness.

The Ministries of Finance and Home Affairs have developed and implemented competent methodologies for analysis of the finance and management conditions of PDAMs and for evaluation of projects, all of which are being made available to the market. Lastly, PDAMs have a large number of investment projects that greatly outstrip the availability of traditional subsidized finance mechanisms from central government. Thus, aggressive PDAM managers are willing to finance projects at commercial rates if it can be demonstrated that the revenue bond mechanism will meet their requirements dependably and quickly.

Therefore, revenue bonds of PDAMs were selected as the first entrants to the market.

A careful selection of potential bond issuers was carried out by the GOI and its consultants. Because water utility performance has been a focus of the GOI since 1992, a computerized database for audited financial results of PDAMs had already been developed to monitor their

financial performance. This system was called into service to identify PDAMs that might participate in the municipal bond program. The financial performance of the country's 300 water authorities was assessed, and those with three years of unqualified audits made the first cut for qualification. Other analyses were later performed, and the list was narrowed to four candidate issuers for the initial bond series.

Estimated Size of the Bond Market

A calculation of the potential size of the market for PDAM revenue bonds (over the next two to three years) incorporated the following factors:

- Of the 300 PDAMs, 50 are healthy or very healthy and have investment projects.
- Half will get subsidized finance (via RDA or SLAs) or use private sector participation.
- Twenty-five PDAMs may use bonds.
- Average project size is Rp 40 billion.

These factors resulted in an estimate of potential demand of Rp 1 trillion over two to three years (about US\$300 million at August 1997 exchange rates).

Revenue Bonds Implementation Program/Tasks

Based on the extensive research and policy dialogue, the decision was made to proceed initially with a Revenue Bonds Implementation Program. The Directorate of Regional Autonomy (PUOD) within the Ministry of Home Affairs officially constituted a "Technical Team" consisting of members from its own staff, the Ministry of Finance, and participating PDAMs. This Team works closely with all market participants (investors, issuers, regulators, and supporting institutions) in a collaborative fashion and is supported technically by the USAID Municipal Finance Project. The basic tasks of the Revenue Bonds Implementation Program, which is now in progress, are as follows:

1. Implement two pilot PDAM revenue bonds:

These pilot issues are to test the regulatory framework and demonstrate the feasibility—as well as the pros and cons—to all market participants. The first two pilot bonds are being prepared by PDAM Badung Kabupaten and PDAM Semarang Kabupaten,² and both are expected to be signed in 1997.

2. Initiate a training and promotion program:

If the pilot issues are successful, implementation guidelines will be prepared to give practical guidance to potential issuers and other market participants regarding the steps required to prepare and execute bond issues. Training and promotional activities based on these materials will be conducted primarily to stimulate interest among potential PDAM issuers.

²*Kabupaten* is roughly equivalent to a county in the United States. In Indonesia, local government takes the form of either a municipality (*kotamadya*) or a *kabupaten*; the latter may include fairly large urban settlements that are not incorporated as municipalities.

3. Institute regulatory and other systematic improvements:

The experience with the pilot bonds is expected to lead to suggestions to make the issuance of revenue bonds more feasible as a source of substantial infrastructure investment funds. The pilots will help to isolate regulatory improvements that may be required and changes to existing project and bond planning, approval, and implementation systems that would enhance the prospects for successful bond financing.

4. Broaden revenue bond implementation:

An additional four pilot PDAM revenue bonds will be supported to demonstrate their feasibility and to develop a cadre of PDAM staff who can advise other PDAMs on bond issuance. Based on market acceptance of PDAM revenue bonds, the scope may be broadened to include revenue bonds for other municipal/municipal enterprise issuers (especially for terminals, markets, and parking).

5. Explore application of general obligations of PEMDAs:

Whereas revenue bonds were selected as having the best prospects for immediate successful application, it may soon be worth exploring the feasibility of issuing general obligation bonds for selected PEMDAs. This activity may become much more feasible after the market has become better acquainted with investing in longer-term, nonsovereign obligations such as PDAM revenue bonds.

Steps in the Issuance of a PDAM Revenue Bond

Table 2.1 shows the main steps in preparing and executing a bond issue. Assuming that a PDAM has a competent corporate plan, a capital improvement plan, and a feasibility study, it should take about six months from the time the firm decision is made to issue a bond until receipt of the bond proceeds.

In both developed and developing markets, the most difficult part of the entire process is to make the firm decision to proceed with the bond issuance. After that, the rest is typically a technical process, the procedures of which become more straightforward and faster as the market develops.

Table 2.1 Steps in the Issuance of a PDAM Revenue Bond

Step	Time needed (months)
• Develop corporate plan/capital improvement plan	---
• Complete feasibility study	---
• Decide to issue bonds	---
• Form PDAM and professional team	1
- underwriter	
- legal advisor	
- auditor	
- trustee/paying agent	
- notary	
- guarantor (if needed)	
• Complete public audit	1
• Prepare prospectus/other documents	1.5
• Obtain PEFINDO rating	0.5
• Register with BAPEPAM	1.5
• Hold bond sale and listing	0.5
Total time from decision to issue bonds:	6

2.5 Advantages and Disadvantages to PDAMs of Using Revenue Bonds

The main sources of long-term debt financing available to PDAMs are subsidized loan programs managed by the central government and, now, revenue bonds. The nominal interest rates for the SLA and RDA loans (11.5 percent) are substantially below current market interest rates payable on revenue bonds (16 to 18 percent) and SLAs do not involve many of the issuance costs required in the issue of bonds (underwriter fees, private audit, etc.). If a PDAM has clear, fast, and administratively painless access to subsidized funds, it is, of course, in its clear interest to use them. However, with so many PDAM projects chasing limited subsidized funds, the result can be uncertainty and harmful project delays compounded by costly administrative procedures.

But bonds also place additional requirements on issuers that other borrowers may not have. Bond issuers are required to undergo audits not only by government, but also by accredited private audit firms. The basis of these audits is the Indonesian Institute of Accountants' generally accepted audit standards.

Therefore, PDAMs must carefully consider the trade-offs of bonds versus the subsidized loan programs on a case-by-case basis.

Revenue bonds pose the following potential advantages.

1. Local decision making and control:

The planning, approval, and execution of the financing are essentially between the PDAM management and the local government chief (who chairs the PDAM Board) on the one hand and the bond investors on the other—without undue involvement of higher levels of government. However, in order to protect the invests and the soundness of the capital market, both PEFINDO and BAPEPAM provide oversight regarding the debt-carrying capacity of the borrower and the viability of the investments.

2. Use of local design standards:

Project design and implementation standards are based exclusively on local Indonesian standards.

3. Shorter approval cycle:

Whereas SLA or RDA loans may involve a two- to three-year approval cycle (depending upon project priority, timing, and availability of subsidized funds), issuing a revenue bond should take about six months from the completion of the feasibility study and firm decision to proceed with issuance.

4. Timely disbursement:

Not only is the approval cycle shorter for revenue bonds but, because the bond proceeds are under the direct management of the issuer, investment project disbursements can be made in a timely fashion.

5. No practical limitations on funds:

If the revenue bond market takes off as expected, there should be ample funds available to meet the needs of creditworthy PDAMs with feasible projects. This fact is in stark contrast to the severe limitations on funds available through the subsidized loan programs.³ We believe that the overall limitation on the bond market will not be the availability of long-term funds in the market, but instead will be the ability of creditworthy PDAMs to prepare projects for investment.

³ These limitations will likely become even more of a constraint as the GOI moves to limit overseas borrowing in the wake of the recent sharp devaluation of the Rupiah.

2.6 Readiness of the Indonesian Bond Market⁴

Size and Depth of the Market

The Indonesian bond market is relatively small, given the size of the economy, with a total capitalization of about one-third the size of the Philippines' bond market. The country has a modest corporate bond market used by private sector companies and some state banks and other national-level, government-owned corporations. The GOI does not issue central government bonds or notes, so no treasury market exists in Indonesia. Private bond maturities have ranged up to 12 years for some toll-road bonds guaranteed by the national government, but generally bond issues have maturities of five years or less. Forty-eight issuers used the bond market between 1988 and August 1995; seven were Regional Development Banks (RDBs), owned jointly by provincial and local governments. The RDBs issued five-year bonds backed by their general revenues. The bond proceeds were used for on-lending to local governments for small projects.

Credit-Rating Capacity

In 1994, the GOI promoted the creation of PEFINDO, the country's first rating agency. Still the only credit-rating agency in Indonesia, it is owned collectively by several private companies, pension funds, and state-owned banks, and by the two Indonesian stock exchanges. In spite of its original sponsorship, the GOI does not have an ownership interest in PEFINDO. This decision was made in order to allow the agency maximum independence and objectivity. As of September 1994, all bonds issued in Indonesia, including municipal bonds, were required to have ratings from PEFINDO. PEFINDO has responded by developing criteria for rating municipal bonds.

Municipal Bond Tax Exemption

No tax exemption is expected to be granted to municipal bonds in Indonesia; in fact, the government is working to eliminate a number of other tax exemptions already in place. It is assumed that municipal bonds will be structured as long-term securities in Indonesia, and because of the shortage of long-term investments in the country, tax exemption is considered to be of limited importance as an incentive for municipal bond purchasers. Large pension funds are tax-exempt but even so are expected to be attracted to municipal bonds because they have few alternative long-term investments to match their long-term liabilities. The government has addressed disincentives to investing in long-term municipal bonds that have been found in the tax law—for example, equalizing tax rates on interest income from bonds and rates on bank deposit interest. Recently, the mutual fund tax policy was also revised, so that individual investors will now pay the taxes on their mutual fund profits, rather than on the fund itself. This change may encourage the development of bond funds, thus attracting more retail investment in bonds, including municipal bonds.

⁴ Information in this section was taken from material on municipal bonds developed by USAID and by James Leigland, personal services contractor to USAID.

2.7 Conclusions

The GOI has approached the development of the municipal bond market the way it has approached most other major policy issues in the urban sector: with a deliberate, consensus-building effort that allows it to test the market without closing other avenues. Already, a number of issues have emerged, even at this early stage, that must be dealt with if the market is ever to develop as a major source of funding.

On the positive side, it is clear that there is a ready group of potential borrowers with bankable projects. There is also a degree of innovation in structuring the bond instruments to extend the maturities via “put options” beyond what is normally found in the Indonesian bond market. The GOI has employed a transparent process to select the first bond issuers on the basis of readiness to participate and has put in place the institutional infrastructure to support development of the bond market.

On the negative side, the municipal bond market must compete on an uneven playing field. Potential borrowers have several choices in the source of capital and each source has powerful advocates. The problem is not the range of choices but the uneven footing on which the different sources often compete. We have noted the availability of subsidized credit through the RDA and SLA mechanisms. In addition, private investors are also promoting various schemes in the form of build-operate-transfer (BOT) and build-operate-own (BOO) as well as concession contracts. These can be legitimate alternatives to debt financing but only if they are selected in a competitive manner and on their own merits.

There are also some issues emerging with respect to the costs of packaging the bond issues. At the early stages, fees for underwriting and associated tasks are high in comparison to the experience in other countries, reflecting both the newness of the activity and the cartel-like pricing found today in the underwriting industry in Indonesia.

The high level of interest rates prevailing in Indonesia also discourages entrance into the domestic capital market—with a corresponding heavy reliance on offshore borrowing across the economy. Indonesia has consistently had one of the higher levels of real interest rates in the region despite good macroeconomic performance over the past decade.

Despite these problems, the need for raising capital for infrastructure investments on the domestic market is all too apparent now. There is considerable debate within the GOI as to which mechanisms are “best” for raising the needed investment capital for Indonesia’s accelerating urban development. The simple answer is that the GOI needs to move forward on all fronts to develop a wide range of mechanisms that can tap domestic resources, both equity and debt, both bonds and loans.

3

Philippines: USAID Experience in Developing the Market for Local Government Bonds

Robert Kehew, PADCO, Inc.

Over the past several years, the United States Agency for International Development (USAID) has provided sustained support to the Government of the Philippines in developing a local government bond market. This paper reviews that work and places it into context. The paper focuses on the project with which the author is most familiar—the Decentralized Shelter and Urban Development (DSUD) Project (1991-95)—and briefly summarizes relevant activities carried out under two other USAID projects.¹ The paper, prepared at the request of USAID's Office of Environment and Urban Programs, reflects solely the opinions and perspectives of the author.

3.1 USAID Objectives and Approach

The DSUD Project responded to Mission objectives. USAID/Philippines' five-year Assistance Strategy (1993-98) included the following relevant objective and outcome:

- **Strategic Objective 1** — more responsive selected democratic institutions with greater citizen participation; and
- **Program Outcome 1.1** — increased local government resources, mechanisms, and models for responsive performance.

USAID developed the DSUD Project² to support cities at a crucial moment in the history of Philippine governance: the passage into law in late 1991 of the Local Government Code (LGC). That Code—whose development USAID had earlier supported via the Local Development Assistance Program (LDAP)—devolved important responsibilities and resources to local government units (LGUs). Whereas this Code marked an advance for decentralization, such a process is not irreversible: Decentralization can perhaps best proceed when local governments can demonstrate that they are willing and able to shoulder new responsibilities. The DSUD Project thus sought to help cities consolidate advances won via the LGC.

The DSUD Policy Matrix spelled out three objectives for the cities: (1) develop a self-sustaining system of financing, (2) improve the delivery of urban services and infrastructure, and (3) improve access to sustainable urban shelter delivery for low-income households. These

¹ Namely, the Local Development Assistance Program (LDAP), which assisted smaller local governments as well as the national government with policy development in the early 1990s, and the ongoing Governance and Local Democracy (GOLD) Project, which was launched in 1995. The author is grateful to James J. Dalton, senior policy advisor on the GOLD Project, for much of this information.

² Project Nos. 492-0388 and 492-HG-001.

emphases reflected a concern that investment in infrastructure and basic services had foundered during a period of rapid urban growth. Recent figures show that roughly one out of five persons still lacks access to safe water,³ and one out of four is denied access to sanitation.⁴ The DSUD Project sought, in part, to help cities capitalize on the new tools offered by the LGC for financing urban infrastructure.

The DSUD Project included two separate pools of resources: US\$50 million in loans backed up by a USAID Housing Guaranty (HG) loan,⁵ and a US\$4 million Economic Support Fund grant. Disbursement of the HG loan was conditioned on completion of a matrix of policy targets designed to strengthen cities. Technically, the DSUD Project embraced several different components: revenue mobilization and financial management systems; urban services and capital investment programming; shelter delivery and planning; and infrastructure investment, the focus of this article.

3.2 Context

Economy and Financial Markets

With a per capita gross national product (GNP) of US\$770 in 1992, the Philippines (population 65 million) can be classified as a lower-middle-income country. Far from sharing in the boom experienced by other Asian economies in the 1980s, Indonesia instead experienced political and economic tumult that resulted in sharp decreases in GNP per capita in the mid-1980s. The 1990s have seen an economic recovery, with the economy growing by 4.3 percent in 1994.⁶

The Philippines' economic backwardness relative to some other East Asian countries is reflected in the comparatively undeveloped structure of its bond market (see Figure 3.1). A snapshot of the bond market in six East Asian countries⁷ in 1994 shows a somewhat diversified group of issuers. As those six countries have generally liberalized their economies and reduced their fiscal deficits, the relative volume of bonds issued by national governments has generally declined as well, while corporate bond activity has increased. This trend was not yet evident in the Philippines in 1994, where the national government still issued 99 percent of all bonds (in terms of value) during that year.⁸

³ World Bank, *World Development Report 1994*.

⁴ World Bank, *World Development Indicators 1997*.

⁵ The U.S. Housing Guaranty Program, established in 1961 and administered by USAID, stimulates U.S. private sector involvement in the financing of low-income shelter and related services in the developing world.

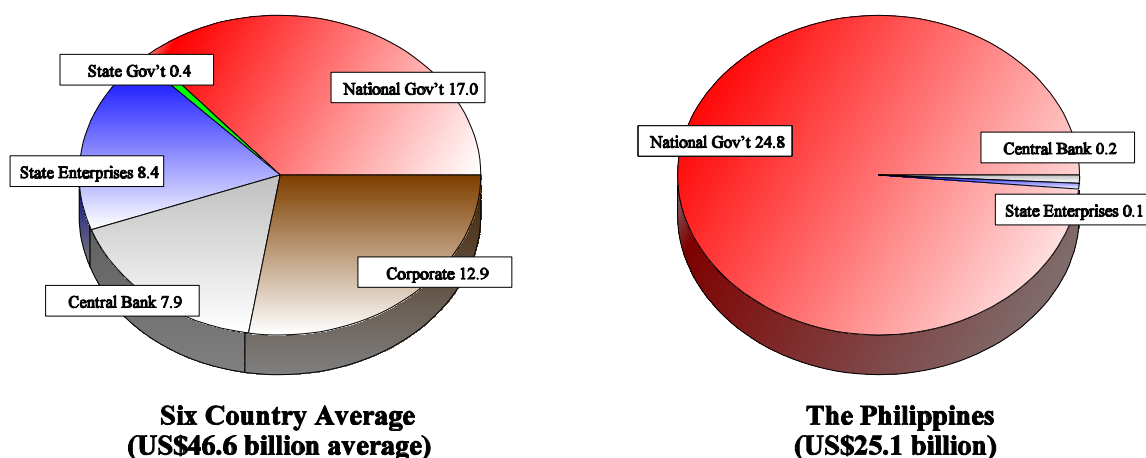
⁶ Asian Development Bank, *Annual Report 1994*.

⁷ Hong Kong, Indonesia, Korea, Malaysia, Singapore, and Thailand. The authors of the article cited found no significant municipal bond activity in any of those countries during the period surveyed.

⁸ Ismail Dalla and Deena Khatkhate, "The Emerging East Asian Bond Market," *Finance and Development*, March 1996, p. 12.

Figure 3.1 East Asia Bond Market

Six Country Average and the Philippines (1994, billion \$)



Six-country average (on left) is for Hong Kong, Indonesia, Korea, Malaysia, Singapore, and Thailand.

Sources: Ismail Dalla and Deena Khatkhate, "The Emerging East Asian Bond Market," *Finance and Development*, March 1996, p. 12; and PADCO, Inc., 1997.

Manila boasts a small but growing stock exchange. In 1994, the total pool of resources available for investment of any type was estimated at about US\$90 billion. This pool included some of the following major groups.

- **Government insurance and retirement funds** — represent about US\$8 billion or 9 percent of the total financial assets of the Philippines. This sector includes the Social Security System, the Government Service Insurance System, and the Armed Forces Retirement and Separation Benefits System.
- **Pension fund** — amounts to about US\$4.5 billion. This sector is expected to grow rapidly over the next few years as recent legislation encourages corporations to pay retirement benefits.
- **Trust funds** — represent about US\$8 billion and are expected to grow rapidly over the next few years with the introduction of flexible, common trust funds.
- **Insurance companies** — with a total investment portfolio of about US\$2 billion.

Other groups of investors include 12 investment houses, various commercial banks, and individual investors. Filipino investors have historically tended to favor liquid, short-term investments. In 1994, investors put 43 percent of their resources with listed stocks, 25 percent

in bank deposits, and 22 percent in Government securities.⁹ As shown below, very little investment has occurred to date in local government bonds. Interviews with investors, however, reveal some dissatisfaction with the limited range of investment options available. One of the main challenges in market development, therefore, is to develop products that tempt investors—who are generally skeptical about new products—into channeling a portion of their resources into an innovative financial instrument: local government bonds.

Local Government Finance

Although a handful of LGUs¹⁰ have issued bonds to date, this instrument at present remains an anomaly in local government finance; its future role remains to be seen. The following discussion places bonds in the broader context of local government finance. At the same time, it introduces the key institutional players and their roles, both before and after the watershed year of 1991.

Prior to Local Government Code (Pre-1991)

While in many ways an exception, Manila illustrates some of the features of urban finance for larger LGUs in the 1980s. In 1985, Manila financed 72 percent of its expenditures from locally raised revenue and 28 percent from external sources—a ratio typical for capital cities in developing countries in the 1980s.¹¹ Local taxes generated over five times as much revenue as did self-financing charges. Two taxes stood out in importance: a property tax and a business tax, representing 62 percent and 32 percent of total tax revenues, respectively. The external sources of financing included grants and shared taxes (24 percent of total revenues) as well as credit (4 percent of total revenues).

In the 1980s, therefore, at least some LGUs were allowed to borrow under restricted conditions, largely from public sources. Table 3.1 presents the major sources for loans. The Municipal Development Fund, which accounted for the highest volumes, also offered the lowest interest rates.

Whereas LGUs did borrow in the 1980s, borrowing never amounted to, on average, more than about 1 percent of their total revenues.¹²

⁹ Jacinto D. Rosario, Jr., “Municipal Bond Markets in the Philippines,” paper presented at National Workshop on Municipal Bond Experiences, December 1995 (Manila: Urbancorp Investments, Inc.).

¹⁰ There are 1,685 LGUs in the Philippines: 78 provinces, 66 cities, and 1,541 municipalities.

¹¹ Roy W. Bahl and Johannes F. Linn, *Urban Public Finance in Developing Countries* (Washington, DC: The Urban Institute, 1992).

¹² USAID/Philippines, LDAP, *Local Government Credit Finance Paper #2*, p. 21.

Table 3.1 Local Government Credit Prior to Local Government Code

Lending Institution	Total Funds Lent to LGUs (pesos^a)	Period	Types of Projects	Interest Rate
Municipal Development Fund	P2.6 billion	1984-91	public markets, etc.	lower than government financial institutions (GFIs)
Government Financial Institutions	P680 million	1975-90	infrastructure, road construction maintenance equipment	lower than commercial banks
Commercial Banks	P325 million	1985-92	—	market rates

^aIn 1995, 25 Philippine pesos were worth about US\$1.

Sources: LDAP, *Local Government Credit Finance Paper #2*, p. 21; and Jim Dalton, interview, September 1997.

Only one local government issued a security prior to the LGC: the Provincial Government of Cebu, which issued its innovative Equity-Bond Units in March 1991. This issue had a par value of P300,000,000¹³; proceeds from the issue were slated to finance various infrastructure projects of the Provincial Government. Upon maturity, the Cebu issue pledged to repay in equity shares of stock; thus, this was not a true bond (which involves repaying a fixed sum of money plus interest). The issue was a conduit security, whereby the sponsoring government undertook no commitment to pay or guarantee the debt service. The issue was instead secured by a joint venture partnership made up of the Province and a private sector partner. The debt was serviced on schedule, with the issue converted into equity shares in 1993.¹⁴ Although ultimately successful, this innovative security unfortunately raised concerns within the investment community regarding local government securities. A year after the bonds were sold, the newly elected provincial governor publicly questioned the lawfulness of the deal, raising the issue of political risk and the specter of possible nonpayment to investors.

Under the Local Government Code (1991)

USAID/Philippines' interest in municipal bonds received a big boost with the passage of the LGC in 1991. In various ways, this Code enabled LGUs to become viable agents of economic development. Besides broadening access to two traditional sources of finance—business taxes and the real property tax—the Code gave LGUs greater access to credit. Similar to previous legislation, the LGC provided that LGUs may issue bonds and other instruments to finance

¹³ In 1995, 25 Philippine pesos were worth about US\$1.

¹⁴ Province of Cebu, *Cebu Equity-Bond Units Prospectus*, 1991; and Cesar Resentes, Treasurer of the Province of Cebu, telephone conversation, 29 March 1995.

“self-liquidating, income-producing development or livelihood projects.”¹⁵ Under the new law, however, LGUs were given greater control over this process. The local council itself could now define the terms and conditions of bond issues, whereas previously the Secretary of Finance and the regulations themselves defined many features of any issue. Unfortunately from the perspective of market development, the 1991 Code did not exempt interest earned on bond investments from taxes (at a 20 percent rate).

The Central Bank regulated the newly enacted legislation via two circulars issued in 1994. For bond flotations without a National Government guarantee, the circulars required LGUs to submit proposals to the Central Bank for an evaluation of monetary and economic impacts. Flotations that sought a sovereign guarantee were required to undergo a more rigorous review process, involving a Central Bank evaluation as well as approval by the Secretary of Finance.

The Home Insurance and Guaranty Corporation (HIGC) used the LGC as the basis to create a new mechanism for financing the development of housing projects.¹⁶ Using a fund established for the purpose, the HIGC guarantees 100 percent of the face value of LGU housing (*pabahay*) bonds, and up to 8.5 percent of the interest payments. The HIGC also set up a program of technical assistance (TA) to LGUs interested in floating such bonds.

While the HIGC funds are limited, by early 1997, three LGUs had taken advantage of the HIGC bond guarantee to help finance housing projects. Key features of those bond issuances—and one other floated without an HIGC guarantee¹⁷—are summarized in Table 3.2 below.

Table 3.2 Local Government Bonds Issued after Enactment of LGC (1991)

LGU/Issuer	Municipality of Victorias	City of Legazpi	Municipality of Claveria	Municipality of Sto. Domingo ^a
Size (US\$)^b	\$320,000	\$1,040,000	\$800,000	\$400,000
Term	2 years	2 years	3 years	3 years
Issue Date	18 Jul 1994	10 Jan 1995	Nov 1995	29 Nov 1996
Interest Payment	quarterly	quarterly	quarterly	semi-annually
Principal Payment	balloon	balloon	balloon	balloon
Interest Rate	variable	fixed	variable	variable
Guarantee	HIGC	HIGC	HIGC	none

^aNueva Ecija.

^bAssumes US\$1 = P25.

Source: Resources and Investments Corporate House, Inc., *The LGU Fund Concept: A RICH Proposal*, 25 February 1997.

¹⁵ This language appears to favor the use of revenue bonds, rather than general obligation bonds.

¹⁶ For two bond issues developed under the HIGC mechanism, revenues generated financed costs associated with purchasing and developing land and constructing housing.

¹⁷ In lieu of an HIGC guarantee, the Santo Domingo issue carried a pledge of up to 20 percent of the municipality's payments from the internal revenue allotment (IRA), a transfer from the central government.

As shown in the table, all bond issues to date have been relatively small (average US\$640,000), short-term (2–3 years), and used to finance the development of housing projects. The two prospectuses reviewed by the author were for revenue bonds.

One notes several other undeveloped aspects of the local government bond market. Looking first at the primary market: No rating system exists for LGUs that plan to issue bonds. Although there is a Philippine rating agency, to date it has not rated LGU securities. At least one of the GFI banks does, however, use a credit scoring system for LGU applicants. Only a small number of financial and legal experts have shown interest in advising local governments on bond flotation. This lack of interest is compounded by the reluctance to date of the Commission on Audit to authorize LGUs to pay such advisors for their services—a stumbling block to market development.

No secondary market currently exists for LGU bond issues. In the short term, this absence can be attributed to the as-yet minuscule size of this potential market. In the long term, however, secondary market development could be constrained by the taxable status of all transfers of government security ownership.

3.3 USAID Activities

USAID has taken the lead among international agencies in the Philippines in supporting the development of a local government bond market. The approach has varied according to circumstances. As noted above, USAID initially supported development of the LGC through LDAP. With the passage of the national legislation in 1991, TA switched to local-level “pump-priming.” By helping to defray the learning costs associated with being the first to enter a new market, the Mission hoped to encourage local governments and investors to become active earlier than they might otherwise. The Mission nurtured and rewarded initiatives that sprung up from the grassroots level. More recently, as the LGC comes up for a legislatively mandated review within the next year, the Mission has supported both national- and local-level activities. Throughout the 1990s, the TA effort has been a learning process, with the Mission and contractors absorbing lessons learned as they went along. Three major activities carried out by PADCO, Inc., under the DSUD Project, as well as more recent developments, are described below.¹⁸

Bond Prefeasibility Study in Quezon City

In the flush of enthusiasm following issuance of the Cebu securities and passage of the LGC, in early 1992, the DSUD Project began a TA activity in Quezon City, a relatively large city adjacent to Manila. The city was interested in financing one or more central business district projects involving city-owned property. While laying the groundwork for an overall capital investment program that would draw on various sources for financing, the team conducted a prefeasibility study to identify the role that bonds could play in such a program.

The team first reviewed the city’s investment priorities to find projects that were potentially viable for bond financing. Preliminary studies that included basic analyses of market demand

¹⁸ Level of coverage of these various activities varies according to the information available to the author.

were prepared for the city's priority sites and projects. An assessment of Quezon City's ability to service debt focused on the city's current fiscal soundness and its future projected revenues.

The exercise identified certain investments that were appropriate for bond financing. Although city leaders unfortunately did not follow up on recommendations for floating bonds, the exercise did develop a model decision-making process that other local governments could replicate in identifying projects appropriate for bond financing.

Local Credit Finance Observational Study Program

Late in 1992, seeking to spark interest in credit financing, the DSUD team offered a local credit finance observational study program. This activity permitted city mayors, provincial governors, national officials, and private sector financiers to examine first-hand the workings of the local government bond market in the United States. During a two-week period, participants visited 24 federal, state, special authority, and nongovernmental institutions that deal with local bond financing. Throughout the trip, participants were prompted to apply what they were seeing to the evolving Philippine context.

Program participants committed themselves to developing a local government bond market in the Philippines. They formed a "Local Government Credit Finance Advisory Association" in an attempt to maintain momentum after the study tour ended. The study program led to some results. The HIGC, which was represented in the program, went on to develop a useful product to help finance housing projects (see earlier discussion), and one participant, the mayor of Naga City, took concrete steps toward bond flotation, as discussed below.

Technical Assistance for Bond Flotation in Naga City

Background and TA Approach

On August 6, 1993, an unusual event occurred in Naga City (population 140,000). On that day, citizens lined up to vote in a public referendum, one of the first of its kind ever held in the archipelago. In that referendum, citizens endorsed not only the construction by the city of a much-needed central bus terminal, but also its unconventional source of financing—local government bonds.¹⁹ That referendum had been preceded by a campaign by the mayor to educate the populace about the need for the project, the associated costs, and bond characteristics. Besides being ratified by an informed citizenry, the bus terminal project had earlier been framed within the context of the city's medium-term development plan, as well as its DSUD-supported capital investment program—all examples of farsighted leadership and good governance.²⁰

Late in 1994, Naga City requested assistance from USAID in advancing the bus terminal project and the related bond flotation. In response, in early 1995, the DSUD Project fielded a team that

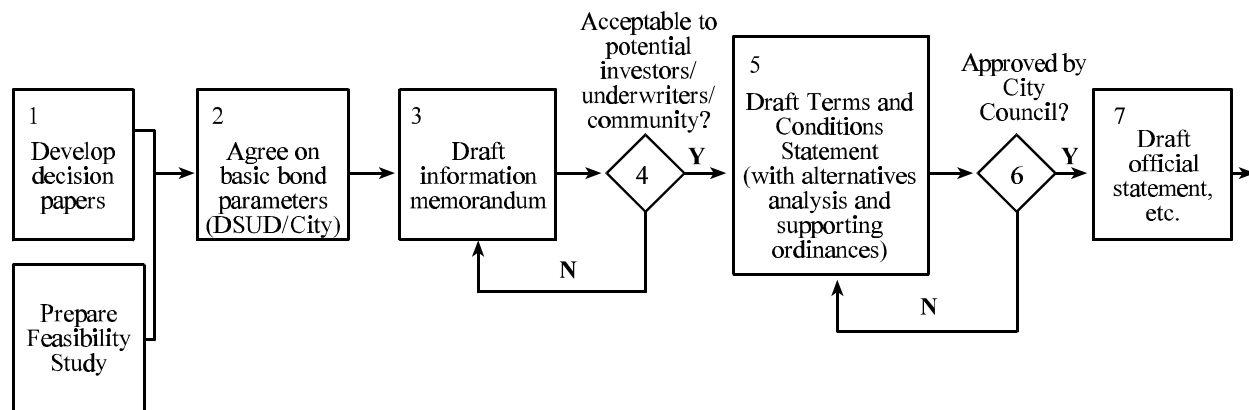
¹⁹ Interviews with Naga officials suggested that the unusual nature of a bond issue and the debt service responsibilities involved were what prompted the mayor to call the referendum.

²⁰ Throughout the Naga City experience, one continually notes synergies between various areas of importance to USAID: good governance; public-private partnerships; and innovative, sustainable municipal finance.

included a financial advisor, a feasibility analyst, and an institutional advisor. Per the mayor's request, the team completed a feasibility study for the bus terminal. The bus terminal project involved a public-private partnership: a private developer offered the city a parcel of land for the bus terminal in the center of a large mixed-use project he proposed to develop.

The assignment's main focus was in structuring the bond issue and seeking City Council approval for the terms and conditions of that issue. To this end, the team developed a participatory approach to bond design that educated local leaders about alternatives and tradeoffs as the bond issue took shape. While developing a bond issue that would fit the project's financial characteristics, offer the best source of financing to the city, and attract potential investors, the process also built local capacity to make informed decisions about financing urban infrastructure in the future. The iterative process, which developed a series of successive approximations to arrive at the final approved terms and conditions, is shown in Figure 3.2.

Figure 3.2 Participatory Process for Determining Bond Terms and Conditions



Acting as financial advisor to the city, the team began by developing a series of decision papers (Step 1). Those papers spelled out 18 key questions, including the following. Are the target investors “large” or “small” or some mix of those groups? Should the issue be term bonds or serial bonds? Should the city seek a national government guarantee for the bond issue? What should the debt coverage ratio be? What should the city's policy be for maximum debt exposure? What pledges of supplemental security should the city make? For each question, the papers offered a brief discussion of concepts, issues, tradeoffs, and experiences elsewhere.

The team next used those decision papers to lead a structured discussion with the city's working group about the bond issue (Step 2). Although city officials brought their own concerns to the process (fiscal prudence, constituency acceptance, etc.), the team sought to inject a sense of market realities into the discussion. The decision papers allowed for a structured discussion that resulted in a near-consensus on some three-quarters of the issues raised, while the remaining issues were deferred for later discussions.

The DSUD team next developed these basic bond parameters, along with a project description and initial conclusions regarding the bus terminal's feasibility, into a draft information memorandum (Step 3). To gauge how well the offering would fare in the marketplace, the team

reviewed the memorandum (and data on the city's fiscal performance) with potential investors and underwriters in Manila (Step 4). Based on the encouraging results of those meetings, the team prepared for a formal presentation to the City Council (Step 5). Besides a draft Terms and Conditions Statement couched as an ordinance, the team also developed two financing options for the bus terminal that involved different debt-coverage ratios. Officials prudently ended up selecting the option that involved less debt obligation.

On March 16, 1995, the Naga City Council approved the terms and conditions of the bus terminal bonds (Step 6). Key characteristics of the bonds are summarized and described below.

Uswag Naga Rainbow Bonds

The City Council voted to call the bond issue the "Uswag Naga Rainbow Bonds." "Uswag" is a word in Bicolano dialect that means "to move forward." "Rainbow" referred to the broad spectrum of investors targeted for the issue and also evoked the "pot of gold" awaiting the potential investor at the end of the investment. Approved bond features are shown in Table 3.3.²¹

Table 3.3 Uswag Naga Rainbow Bonds: Key Terms and Conditions

Name:	Uswag Naga Rainbow Bonds		
Amount of Issue:	US\$1.8 million equivalent in pesos		
Purpose:	To finance the construction and development of the Naga City Central Bus Terminal		
Term/Maturity:	The bonds shall have the following maturity dates.		
	1st series	P5.0 million	Two (2) years
	2nd Series	P6.25 million	Two (2) years
	3rd Series	P11.25 million	Three (3) years
	4th Series	P11.25 million	Four (4) years
	5th Series	P11.25 million	Five (5) years
Interest Rate:	Floating rate, maximum of 4.0 percent per annum over average 182-day T-bills rate based on latest auction by Bangko Sentral, as follows: 1st Series – 2.5 percent per annum over T-bills; 2nd Series – 2.5 percent per annum over T-bills; 3rd Series – 3.0 percent per annum over T-bills; 4th Series – 3.5 percent per annum over T-bills; and 5th Series – 4.0 percent per annum over T-bills.		
Form:	Registered or bearer		

²¹ Arguably, certain features of the bond design could have been left to a later phase of the process, and not subjected to a City Council vote. The approved Terms and Conditions, however, were not set in stone; they undoubtedly could have been revised during subsequent negotiations with an underwriter, etc. The technical assistance exercise left the City Council better equipped for those negotiations.

Denomination	US\$20, 40, 400, 4,000, and 40,000 equivalent in pesos
Manner of Sale	Public issue through an underwriter
Fiscal Agent	A government bank to be appointed to act as trustee, fiscal agent, fund manager, custodian, and/or transfer agent
Underwriting Fee	A one-time fee equivalent to 2 percent of the face value of the bonds
Selling Commission	A one-time fee equivalent to 1 percent of the amount of the bonds sold
Trustee Fee	One-half of 1 percent per annum of the face value of the bonds

If issued as designed, the Uswag Naga Bonds would have represented the first bonds issued in the Philippines by an LGU without a national government guarantee,²² the first example of serial bonds rather than term bonds, and the longest term to maturity of any securities issued to date.

The terms and conditions approved illuminate some of the concerns experienced by a city council poised to contract long-term indebtedness in a new market. First, to maintain public support of the project and increase local accountability, Council members sought to provide for the local sale of at least a portion of the bonds. They did so first by providing for a portion of the bonds to be issued locally in very low “mini-bond” denominations beginning at US\$20. The Council also sought to provide for a liquidity pool for holders of low-denomination bonds. The City Council sought these provisions despite the team’s observation that both provisions could add substantially to the costs of administering the issue.

Second, city officials supported by the DSUD team sought to provide prospective buyers with adequate security for their investments. Should the bus terminal not produce adequate revenues to service the debt, the City Council provided for a series of fallback securities, including a deed of assignment of the city’s share in the internal revenue allotment from the national government. The City Council also provided for a debt service reserve fund, the appointment of a bond trustee, and additional recourse for investors.

Following approval of the bond issue’s terms and conditions, the team prepared a draft prospectus (Step 7). With the DSUD Project about to close, the team helped the city develop a detailed plan of actions to take over the next several months leading up to bond flotation. The action plan included guidance for selecting and working with an underwriter, a financial advisor, etc.

Unfortunately, to date (September 1997), the Uswag Naga Rainbow Bonds have reportedly still not been floated. Armed with the bus terminal feasibility study, the Naga City mayor has reportedly been exploring alternative, less-costly sources of financing with various financial institutions. To date, the city has reportedly still not identified an alternative source of finance (see Section 3.4, Conclusions and Future Directions, below).

²² This has since occurred. See Table 3.2, above.

Recent Assistance (1995-Present)

Since 1995, USAID/Philippines has provided assistance via the GOLD Project, with international support led by ARD, Inc., with PADCO, Inc., as a subcontractor. At both the national and the local levels, the GOLD team is assisting in various areas of local government finance. As the LGC comes up for a legislatively mandated revision, the team is helping lawmakers and other concerned parties (e.g., the League of Provinces) analyze and work to improve the Code, including its provisions regarding local government bonds.

Among other issues, the GOLD team would particularly like to persuade legislators to make local government bonds tax-exempt. The Naga City experience appears to illustrate local officials' concern in financing projects at the best possible terms. Investors likewise have their own investment criteria. As in the United States, the tax-exempt status for local government bonds could be the market-maker that allows these instruments to compare favorably with other financial instruments available to local officials, while at the same time clearing investors' hurdle rates. To explore and illuminate this issue, the GOLD team is currently (September 1997) preparing a simulation study of the various impacts that making local government bonds tax-exempt would have on budgets and investment decisions.

3.4 Conclusions and Future Directions

Despite initial optimism and strategic technical support from USAID in such places as Naga City, use of bonds to finance urban infrastructure under the 1991 Local Government Code has been disappointingly limited. As shown above, local governments have issued only a handful of small bonds to date. The great majority of LGUs are apparently willing to wait in line for grants and concessionary credit. As noted above, USAID/GOLD is examining the institutional and market constraints that have prevented broader use of local government bonds and is supporting the revision of the LGC. Constraints identified include two obstacles mentioned above (the lack of tax-exempt status for bonds and the stance of the Commission on Audit regarding LGUs paying for outside advice) and others (e.g., possible restrictions and uncertainty on establishing an intercept mechanism on the Internal Revenue Allotment).

The lack of a diversified portfolio of bond issuers in the Philippines shown earlier in Figure 3.1 hints at broader market constraints. Other efforts to overcome obstacles to local government bond issuance by establishing credit enhancement mechanisms, financial products, etc., are also under discussion. The modest success of the HIGC in stimulating the use of bonds to finance housing projects is worth considering. The credit enhancement package offered by that institution—credit guarantee plus TA for a specific type of project—could potentially be duplicated by other sectoral line ministries and agencies involved in providing basic urban infrastructure.

Whereas examining ways to invigorate the local government bond market is a worthwhile exercise, it also appears appropriate at this time to take several additional steps backward. One should not assume that local government bonds are a panacea for the shortfall in urban infrastructure and services. Officials should take a hard look at the role that other financial sources and instruments might play. This more comprehensive review is happening at least in part: the Government of the Philippines and the World Bank have reportedly been examining ways to restructure the Municipal Development Fund. But other unused or underused mechanisms and sources, such as system development charges, developer contributions,

assessments, private sector participation etc., might also have roles to play. A comprehensive review of the provision of urban infrastructure and services might also turn up related obstacles and issues, such as, perhaps, the efficiency of service provision, the tradeoffs between high standards and affordability, etc.

Other countries have succeeded in placing individual financing sources and mechanisms within a comprehensive policy framework for urban infrastructure finance. One way in which such a framework could help clarify roles would be to propose varying sources of financing depending on the size and characteristics of individual local government units. Larger or more creditworthy LGUs could, for example, be oriented more toward the market, while smaller LGUs could be targeted for concessionary sources of finance. As markets and the roles of various potential players are clarified, more capital from all sources may become available. With an urgent need for basic urban infrastructure and services, and the LGC coming up for revision, the time is ripe for the Philippines to take a comprehensive look at its overall strategy for urban infrastructure finance.

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4

Poland: General Overview of the Municipal Bond Market¹

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4.1 Municipal Bonds in Poland's Local Government Financial System

As local governments in Poland assume more capital investment responsibilities, particularly for engineering infrastructure projects, they are more actively looking for sources of long-term funds other than bank loans. This growing demand for external funding is a defining characteristic of Poland's municipal finance system. Inadequacy of the banking system and lenders' insufficient understanding of local governments' borrowing characteristics, however, have prevented close cooperation between municipalities and financial institutions. Consequently, municipalities' reserves decrease and their indebtedness increases.

Article 25 of the 1993 Law on Municipal Finance provides municipalities the general right to issue securities. The law restricts how much debt a municipality can accumulate by limiting to 15 percent of expected revenues principal payments on loans and credits not secured by municipal property and/or redeemable securities. Municipal bond issuance is regulated by the 1995 Law on Bonds. Updating a 1988 law, these new regulations took greater consideration of local government expectations and needs. The 1991 Law on Public Trading in Securities and Mutual Funds regulates publicly issued bonds (i.e., those offered to at least 300 buyers).

Although they lacked experience and there were no executive provisions or Securities Commission regulations, several cities initiated the bond issuance process in early 1996 (see Table 4.1 at end of paper). The City of Gdynia and the City of Łódź each have issued nearly Zł 30 million in bonds to purchase public transportation vehicles. The City of Kraków will float a Zł 15 million issue to complete construction of a public transportation center, modernize streets, and fund a high-speed tram project. The City of Gdańsk, whose Zł 99 million planned issue is the country's largest, will use bond proceeds for road repair and modernization and for new public transportation vehicles. A leader among smaller cities, the City of Ostrów Wielkopolski, whose first issue totalled Zł 7.5 million, has developed an offering memorandum for bonds sold in the over-the-counter (OTC) market. The City of Gorzów Wielkopolski is the first city to use a competitively selected issue organizer for its Zł 20 million bond issue for road repair and construction. Poland's cities use bond proceeds for more than just transportation projects: The City of Tarnobrzeg's Zł 10 million bond sale will fund several capital projects. Other municipalities planning to issue bonds in the future expect to finance municipal infrastructure investments, particularly those that will generate future revenue.

¹ Adapted from a publication sponsored by the U.S. Agency for International Development (USAID) and the Poland-Hungary Aid for Restructuring of Economies (PHARE) Fund, December 1996.

Bonds can be a source of financing for smaller municipalities as well as large, metropolitan cities. Small cities, who have expressed a strong interest in this form of debt, can pool their bond issues, allowing them to fund road modernization projects, public transportation improvements, and shopping mall and housing construction. The average city plans to issue Zł 10 to 12 million in bonds, although a few large cities are planning considerably larger issues. Based on the most current information from the Municipal Development Account (MDA), which fosters the development and improvement of municipal finance, new bond issues for 1996 total about Zł 250 million.

Although capital improvements tend to increase as budget revenues increase, capital expenditures as a percent of revenues does not change. It is interesting to note, however, that this percentage is higher in medium-sized cities than in large cities. In small cities the portion of revenues dedicated to capital improvements varies from town to town.

Municipalities encountered several difficulties as they entered the municipal bond market. They had no experience with issuing securities, and few Polish experts were available for assistance. Potential investors were wary of municipal securities, which were an unknown commodity. Issuers also needed to create a secondary market for their securities. To assist Polish municipalities in overcoming these challenges, U.S. and European organizations provided technical assistance. Polish banks also participated in the emerging bond market's development, especially by structuring the issues.

Additional assistance came from the MDA. The MDA surveys municipalities' interest in and capabilities of issuing securities and determines the assistance most needed by municipalities. At least five of Polish municipalities working with MDA indicate that they are prepared to issue securities in the near future.

Some local government representatives have expressed concerns that municipalities face too many obstacles to issue bonds successfully. These obstacles include the privileged tax treatment awarded to national Treasury bills, insufficient demand from large investors, the high cost of issuance, and a lack of tradition in municipal securities investment. Members of city boards and councils claim that most Polish municipalities have neither sufficient expertise nor the access to qualified experts to make informed decisions. Municipalities need manuals, training programs, and every other form of technical assistance.

Local governments in Poland agree that embarking on the public issue would be too expensive, and thus unprofitable, at this point. All upcoming issues are therefore likely to be private. Local authorities do suggest, however, that introducing municipal securities to the public market might attract new investors. State administration bodies, banks, and MDA have undertaken a number of actions to develop regulations and mechanisms that would facilitate creation of the secondary market for municipal bonds, especially those traded on the OTC market.

It is interesting to note that almost all of the municipalities that are planning to issue securities have often used bank loans as a funding mechanism for capital projects. Municipalities that plan to issue bonds have been financing a higher percentage of their capital expenditures from external sources (e.g., bank loans, state subsidies, loans and grants from special funds) than those that have not expressed much interest in entering the municipal bond market. Although one must be cautious in drawing conclusions from the limited data available, one can reasonably claim that active municipalities—those that often rely on external funding sources

and follow investment policies based on long-term development strategies—display greater interest in prospective issuance efforts than other cities.

An examination of municipal finance operations in recent years reveals that municipalities tend to borrow from special funds, especially the National Environmental Fund, where cities receive preferential treatment; however, these loans compose only a small fraction of municipality's revenues. In addition, most Polish municipalities tend not to use bank loans. The reasons for this include the instability of municipal revenues and the difficulty of finding acceptable forms of collateral when traditional forms such as mortgages or liens are limited, insufficient, and inefficient for cities. Legal debt caps could affect municipalities' use of bank loans, although the vast majority of municipal debt payments are far below the cap. As municipalities gain more experience with borrowing, however, their position in capital markets strengthens and investors see them as more reliable financial partners.

Although bonds presently account for only a small percentage of debt finance, most municipalities that plan to issue bonds will forego their use of bank loans and rely on bonds as their main external source of funding. The municipal bond market is growing faster than the market for bank loans, a fact that should not be exclusively attributed to their attraction as a new product on the Polish capital market. Municipal associations are hinting that they plan to issue bonds as well. A growing number of financial institutions are interested in organizing Polish municipal bond issues. The number of entities available for assessing bonds' cost-effectiveness and municipalities' credit-worthiness and capability as bond issuers is also increasing.

4.2 Municipal Bond Market in Poland: An Overview

Private Placement vs. Public Issue

All issues of municipal bonds carried out as of the date of this report have been offered exclusively to a nonpublic market. Private placement, however, can be restrictive and inconvenient for both the dealer (i.e., the seller of bonds) and individual investors. Since private sales can be offered to no more than 300 potential investors, the issue organizer's selection of the market can significantly affect the success and profitability of the issue. In addition, announcing a private offer for sale in the mass media is prohibited under Polish law, which further restricts the bank's ability to market the issue. Long-term municipal securities must be printed, and regulations do not allow for the issuance of group coupons. If the bank wants to avoid printing the bonds in the state securities' printing house but ensure basic security against forgery, a proper depository must be established.

On the other hand, public issues require lengthy and costly procedures for municipalities. Amendments to the Council of Ministers ordinance that regulates the prospectus and offering memorandum, which became effective in late 1996, place onerous obligations on municipalities. For example, the requirement that financial statements (i.e., three-year information on assets and liabilities, budgets, and additional information) be verified by auditors burdens municipalities with additional costs. From a cost-benefit perspective, many local government would be unwilling to offer a public issue under these conditions. The only city that is preparing to trade its bonds on the secondary market has received significant technical and financial support from foreign assistance organizations. Other municipalities will have to rely exclusively on their own limited resources.

As long as investors are uninterested in municipal bonds or do not value the liquidity municipal securities in the secondary market provide, municipalities will continue to choose private placement for their bonds.

Underwriting

None of the municipal bond issues put forth so far has been fully underwritten. A full underwriting consists of the issue organizer (or another contracted institution) purchasing all the bonds and reselling them to a third party. Under this arrangement, the municipality does not have to worry about being able to sell all the bonds, and the underwriter assumes the full credit risk for the bonds until it sells them. Using a competitive bidding process, a municipality should select the underwriter according to the true interest cost (see the third part of Section 2.3). Although the "shopping procedure," whereby an underwriter is chosen based on general criteria and then the details are negotiated, resembles the U.S. negotiated sale model, critics claim that it is a "beauty contest" and that most municipalities are unable to negotiate better terms than they would have achieved through competition. Most Polish municipalities, however, lack the expertise to complete the competitive process.

Relying on the market is another way of determining the cost of interest, which reflects the profitability of a bond issue. The most efficient method of testing the market is "book building," which involves soliciting expressions of interest from dealer organizations which will later sell the bonds on the secondary market. One Polish city that has successfully used this procedure secured itself against the risk of excessive cost by setting ceilings for the sale price and the nominal interest rate. In this case, the bond issue was not fully underwritten, but the organizer committed to buy at the lowest offered price whatever bonds were not purchased by other investors.

Although underwriting frees the municipality from issuance risk, the city still must address the issue of credit risk. The Law on Bonds does provide options for hedging against credit risk; however, most issuers have not used them, and it is unlikely that they will do so in the future. Municipal issuers have satisfied investors by preparing analyses and forecasts of their current and future financial standings. This indicates that there is no need for municipalities to employ traditional, often costly, forms of securing lenders' interests.

Cost of Issue

Total cost of bond issuance covers the cost of interest (i.e., interest paid to investors) and the cost of preparation and organization of the issue.

Cost of Interest

To reduce the risks associated with high inflation and changes in the value of the Polish zloty, municipalities have issued bonds bearing variable coupon rates. Municipal bonds are also adjusted to the yield of 52-week Treasury bills. The yield to maturity for T-bills is calculated as the average of quotes at two to four bidding sessions preceding an interest period, which often results in small differences in yields among individual issues. The coupon rate for a given interest period is calculated at the end of the previous period. Bonds with relatively short maturities often have coupon rates calculated for all interest periods before issuance. This method of compounding interest guarantees the investor some additional income to offset

inflation. Shorter interest periods can be used; for example, the coupon rate for bonds issued in a three- or six-month interest period can be tied to 13- and 26-week T-bills, respectively. In considering changes in the standard period of calculation, however, issuers must analyze the impact on interest rate risk—one of the most important elements in a potential investor's decision to purchase securities. It is virtually impossible to calculate the true interest cost of a variable-rate security without using complicated, and often biased, computation techniques to develop projections of future interest rates.

Another component of the cost of interest is the investor's margin. The investor's margin—or profit—induces investors to assume a greater risk and purchase municipal bonds rather than T-bills. The investor's margin, which varies according to the issuer's credit-worthiness, is usually set during the negotiations between the issue organizer and the issuer. Table 4.2 (at end of paper) illustrates the rates of investor's margin for various issues.

Cost of Preparation and Organization of Bond Issue

There are several costs to plan for when issuing bonds. Municipalities must budget for staff overtime and more extensive use of computers, telephones, and paper. There are also costs associated with placing the bond issue and conducting advanced financial analysis for the benefit of potential investors. Since municipalities in Poland often lack the technical expertise to size and structure the bonds, they must also plan on the costs of retaining assistance from qualified professionals. Some municipalities entrust this job to the issue organizer. This approach has advantages and disadvantages. It does save municipal staff time and effort, and it provides a level of comfort to the bank, which can adjust the terms of issue to suit its own financial and operational capabilities. On the other hand, the bank will charge a higher commission fee, and municipalities must evaluate a bank's qualifications for this work as they consider possible tenders.

Outlays incurred for selecting an issue organizer for the issue is another cost item, the amount of which depends on the selection method. Using a negotiated approach with some elements of competition helps minimize these costs, but the method has its disadvantages. For example, it does not allow for objective comparison of many bidders, and issuers tend to make their selection based on one criterion that is frequently detached from the broader financial context. A competitive bidding procedure requires high level of expertise, or hiring an external consultant, but it offers greater assurance that the municipality is selecting the best tender. It also gives the appearance that the municipality's processes are untainted by impropriety, which is of considerable importance for the municipality's image as a market participant. The issue organizer's commission fee depends on the quality of the issuer's financial analysis and structuring of the issue. For complicated issues, commission fee may cover the cost of (1) verifying the analyses and studies conducted by the issuer, (2) preparing the offering memorandum, (3) underwriting the issue or selling bonds to investors, and (4) organizing the secondary market.

Total True Interest Cost

The cost of bond issuance is not equal to the interest rate, nor is the organizer's commission fee a sole indicator of issuance cost. The true interest cost (TIC) equals the yield to maturity (i.e., profitability) and the bank's commission fee. Profitability is a function of both the interest rate and sale price of bonds. In a variable interest rate environment, however, it is impossible to calculate profitability and, hence, TIC. Likewise, the bank's commission fee depends on the

level of effort the bank will put forth. If a municipality does not have adequate equipment and technical expertise to prepare financial analyses or structure the issue, either the bank will charge a higher fee or the municipality should hire external consultants, both of which will affect the total TIC.

Bidding Procedures

When choosing a service provider, the selection procedure should guarantee equal opportunity for all competitors to present their technical and financial potential in full. This allows the municipality to identify the tender that will best perform the service according to the city's needs for the most attractive price.

Method Selection

According to the Law on Procurement, there are two methods for selecting organizer services: a two-phase competitive bidding process or negotiations with elements of competition. Prior to the law's implementation, cities used a method that can be referred to as "shopping," with selection criteria defined somewhat arbitrarily. Only two cities have selected issue organizers since the law was implemented.

Under competitive bidding, the issuer develops specifications for a service order (i.e., a request for proposals) which is distributed to potential service providers (i.e., issue organizers). Responding financial institutions indicate how much they would charge for the services specified in the order. This allows for a fair, quantitative comparison of the costs of issue organizers' services. Developing the specifications for the service order, however, may require a knowledge of the securities market that municipalities may not possess.

With the negotiation method, financial institutions may infer that a municipality is not being forthcoming in its selection process. The negotiation process may, in fact, result in decisions based on issues other than a service provider's technical qualifications or price. Compared to competitive bidding, however, this method is far less labor-intensive and does not require thorough securities-market knowledge. Time may be an important factor when the municipality chooses a method: a two-phase competitive bidding procedure takes between three and six months, while all required activities for negotiations can be carried out in a few weeks.

Evaluation of Tenders

The current level of market development precludes the use of quantitative methods in the evaluation of tenders. The issuers who used these methods frequently made the basic mistake of basing their assessments exclusively on nominal interest rates or commission fees, neither of which reflects the true costs of service. One municipality was successful in combining both qualitative and quantitative criteria, requesting that tenders indicate a range of interest rates for a minimum issue price. As the market develops and services become more standardized, use of underwriting and true interest cost as the bases of cost assessment is likely to increase in Poland.

Offering Memorandum

Disclosure standards for a private placement are not as rigorous as they are for a public issue. For the sake of investors, however, municipalities usually prepare an offering memorandum, which details the municipal securities' characteristics. Most memoranda present information on the size, structure, and purpose of the issue; the structure and composition of municipal authorities; the projects to be financed with bond proceeds; and the financial standing of the issuer, including the size and structure of its budgetary revenues and expenditures and its debt. The document also includes a Regional Audit Office opinion, historical budget data, and the basic parameters for the issue-year budget. The memorandum prepared for the city intending to trade its bonds in the OTC market presents more extensive and detailed information than required. As a result of this city's experiences, the Council of Ministers has drafted an ordinance, which the Polish Securities Commission will review, to delineate the requirements offering memoranda and prospectuses should fulfill.

Table 4.1 Basic Data on Municipal Bond Issues in Poland

Issuer	Bank (Issue Organizer)	Value (in Zł)	Purpose	Coupon Structure	Investor's Margin	Bank Selection Method
Gdańsk*	Bank Gdańsk i, Bank Handlowy Merrill Lynch	99.3 million	Public transportation vehicle replacement, road repairs, construction of a sewage collector	Annual, variable interest rate: base rate = mean of weighted profitability rates of 52-week T-bills	Component: 0.50% - 1-year 0.70% - 2-year 1.00% - 3-year 1.05% - 4- and 5-year	Shopping procedure
Gdynia	ING in cooperation with Bank Komunalny S.A.	28 million	Public transportation vehicle replacement	Annual, variable interest rate: base rate = mean of weighted profitability rates of 52-week T-bills	Component: 0.50% - 1-year 0.75% - 2-year 1.00% - 3-year 1.25% - 4-year	Shopping procedure
Gorzów Wielkopolski	Bank Handlowy, Gospodarczy Bank Wielkopolski	20 million	Road repairs	Annual, variable interest rate: base rate = mean of weighted profitability rates of 52-week T-bills	Component: set through book-building max. 1.05% - 3-year max. 1.10% - 4-year	Two-phase bidding
Kraków*	Bank Przemysłowo- Handlowy, Bank PKO S.A., Bank Współpracy Regionalnej	15 million	Various projects	Annual, variable interest rate: base rate = mean of weighted profitability rates of 52-week T-bills	"0" margin	Shopping procedure
Łódź	ING, Bank Śląski, Bank Przemysłowy S.A.	29 million	Public transportation vehicle replacement	Annual, variable interest rate: base rate = mean of weighted profitability rates of 52-week T-bills	Component: 0.35% - 1-year 0.65% - 2-year 0.90% - 3-year 1.15% - 4-year	Shopping procedure
Lublin	Bank Depozytowo- Kredytowy	90 million	Various projects	Annual, variable interest rate: base rate = mean of weighted profitability rates of 52-week T-bills	Component: 0.50% - 1-year 0.75% - 2-year 1.00% - 3-year 1.25% - 4-year 1.50%	Shopping procedure
Miejsko	Gospodarczy Bank Wielkopolski	1 million	Construction of a sewage treatment plant	Annual, variable interest rate: base rate = mean of weighted profitability rates of 13-week T-bills	Multiplicative margin: 1.15%	Shopping procedure

Issuer	Bank (Issue Organizer)	Value (in Zł)	Purpose	Coupon Structure	Investor's Margin	Bank Selection Method
Ostrów Wielkopolski	Bank Handlowy	7.5 million	Road repairs	Annual, variable interest rate: base rate = mean of weighted profitability rates of 52-week T-bills	Component: 1.32% - 3-year	Shopping procedure
Tarnobrzeg	Bank Ochrony środowiska	10 million	Old Town District renovation, school construction, city housing projects	Annual, variable interest rate: base rate = mean of weighted profitability rates of 52-week T-bills	Component: 1.70% - 5-year	Negotiations with elements of competition

* Planned bond issues.

Table 4.2 Municipal Bond Issuance Procedures

Main Procedures	Supplementary Procedures	Legal Basis	Responsible Parties	Comments
Identify issue purpose (e.g., recurrent operations or capital investment projects)	<ul style="list-style-type: none"> Municipal development strategy Preliminary budget analysis Compare the cost of the bond issue against a bank loan (bond issue should be more cost-effective) 	Article 5, para. 1, item 3 and Article 41 of the Law on Bonds	Issuer (i.e., a municipality, municipal association, municipal joint stock company, or municipal enterprise)	The issue purpose should be based on the municipality's development strategy, investment plan, and credit-worthiness; if bonds are issued to supplement the operating budget or to meet Law on Physical Planning requirements, this is not necessary. The issue purpose must be printed on the bonds and stated in the offer for sale. Funds cannot be spent on other projects. Outside consultants should be consulted for issue purpose development.
Select an institution to prepare the issue (i.e., its framework)			Municipal Board	The institution will develop the issue's structure, offer suggestions as to its form and terms, and provide legal and financial consultation until the organizing bank has been contracted. This institution can be a consulting firm, bank, or a brokerage house, or it can be a nonprofit, public sector organization. The institution must be selected according to the Procurement Law unless it is providing its services without charge.
Investment appraisal	<ul style="list-style-type: none"> Preparation of technical documentation Development of a business plan and feasibility study 		Institution preparing the issue	This appraisal is only required If the bond proceeds are for capital investment projects.
Authorize municipal board to issue bonds, specifying the goal and budgeted expenditures	<ul style="list-style-type: none"> Consult with Regional Audit Office 	Article 18, para. 2, item 9, letter b of the Law on Local Governments	Municipal board and institution preparing the issue draft resolution for municipal council approval	Regional Audit Office verification of the resolution is not a legal requirement; however, consultation may prevent future conflict.
Select representative bank		Article 29 of the Law on Bonds	Municipal board makes selection with consultation from the institution preparing the issue	Required for every public issue with a maturity of one year or greater. A representative bank is not needed in a private placement.
Specify terms of issue		Article 18, para. 2, item 9, letter b of the Law on Local Governments and Articles 5–10 of the Law on Bonds	Municipal board and the institution preparing the issue (Also the guarantor and the representative bank, if needed)	If a bond issue is guaranteed by another municipality or the state treasury, the guarantor should participate. If it is a public bond issue, the representative bank should be involved.

Main Procedures	Supplementary Procedures	Legal Basis	Responsible Parties	Comments
Approve bond issue resolution (Regional Audit Office and Voivodship Office inspections)	<ul style="list-style-type: none"> Sign a contract for public market representation 	Article 25, para. 2 of the Law on Municipal Finance	Municipal council	For public issues, the municipality must contract with a broker to introduce the issue to public trading and with the representative bank.
Select bond issue organizer	<ul style="list-style-type: none"> Conduct bidding procedure Sign a contract for services 		Municipal board conducts bidding procedure with consultation from the institution preparing the issue	Bond issues should be organized by a bank or a broker, although other organizations can be employed if it is a private placement. The institution preparing the bond issue should not be the bond issue organizer, but this does not preclude later cooperation between the two entities.
Analyze the municipality's credit-worthiness	<ul style="list-style-type: none"> Analyze bond issue cash flow 	Article 24 of the Law on Municipal Finance	Institution preparing the issue, issue organizer, and rating agency	Several independent opinions of credit-worthiness should be obtained. For bond issues traded internationally, the opinion of a reputable rating agency is indispensable.
Identify prospective investors	<ul style="list-style-type: none"> Contract with agent, dealer, and/or underwriter 		Issue organizer	Depending on the structure, the issue organizer may act as agent (who prepares the securities, takes care of their deposit, and services the primary and secondary market), dealer (who places the issue on the primary market), and/or underwriter (who will purchase bonds not sold to investors). The issue organizer may contract with other entities to perform these services.
Document the issue			Municipal board and issue organizer	For public issues, the municipality must prepare a prospectus and apply to the Polish Securities Commission for the bonds to be admitted to the public market. In the OTC market, only an offering memorandum is required.
Prepare the offer for sale			Issue organizer	
Issue the offer for sale, publish the prospectus, place bonds		Article 10, para. 1 of the Law on Bonds	Issue organizer	For public issues, a prospectus and public subscription must be published.
Issue a bond document				In public trading, bonds are not printed; rather a group coupon is issued and deposited with the Polish Securities Commission.

5

Russia: Regional and Local Borrowing

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5.1 Introduction

Local and regional governments in Russia have been assigned increased responsibilities for service provision and for construction, maintenance, and finance of capital infrastructure. The old system of financing capital investments from the national budget is no longer viable. The Russian national budget cannot and need not support capital infrastructure investments throughout the country. Even if it could, cities that must depend on central government largesse are also subject to the central government deciding when, how, and if they will receive funds. In trying to cope with increasing spending responsibilities, cities and regions in Russia in growing numbers are turning to borrowing as a source of funds for local programs.

USAID has played an important role in helping to develop understanding of the basic concepts of capital finance and creating the major components of markets for local borrowing. The Municipal Finance and Management (MFM) Project, sponsored by USAID, delivered capital finance training and technical assistance to a number of cities with capital investment needs. Another USAID-funded activity, the Housing Reform Sector Project, focused, among other things, on developing sound infrastructure projects that could be financed by borrowing on the private market.

This paper examines the trends in regional and local borrowing in Russia. This market is still in its infancy, but because of improving economic conditions, is expected to gain substantially vis-à-vis federal and corporate securities.

5.2 The Origins of Sub-Federal Borrowing in Russia

The term “municipal bonds” is used in Russia to mean truly municipal (local) obligations, and to an even greater extent, bonds issued by sub-federal (regional) units of government. Regional bonds tend to dominate the sub-federal market, even though they are issued for local purposes. There are a number of reasons for this: (1) municipal governments do not have either the clout or the technical capacity to implement a bond issue; (2) regional governments can offer greater security to bondholders by pledging their sources of income; and (3) securities of regional governments enjoy the same tax-exempt status as government obligations, making them much more competitive than local bonds, which are not tax-exempt. In sum, regional bonds are often a cheaper financing vehicle for local programs.

Regional bonds first appeared in Russia in 1992, when two regional governments—Khabarovskij Kraj and Nizhni Novgorod oblast—issued their first obligations. However, financial conditions at the time were extremely unfavorable; inflation had spiked to 2000 percent and avenues for investment were drying up. Since then the situation has improved considerably, and at the time of this writing, the majority of the 89 regional governments were using borrowed resources, or at least considering doing so. However, the amount of regional borrowing as a share of total value of state and corporate securities available on the market is small—only about 3 to 4 percent.

5.3 Major Types of Bonds

The three types of bonds used most often in Russia are short-term general obligation notes, housing bonds, and arbitrage bonds. Each type is described below.

GKO-Type Bonds

Short-term general obligation notes—referred to as “GKO-type bonds” because they are patterned on the short-term zero coupon notes (GKOs) issued by the federal government—are the most heavily used instrument, accounting for about half of the total amount of sub-federal borrowing. The notes usually supplement the local general fund and, as such, are not earmarked for any specific purpose; proceeds are used mostly to cover operating expenses. The bonds typically are secured by the issuer's revenues and property. St. Petersburg is the largest issuer of these instruments in Russia, filing for issuance of about \$1.3 billion worth in 1996. For most issuers, the notes are being rolled over, meaning that debts are repaid from subsequent issues. In that sense, these instruments are most likely to get local governments into trouble, since they are in essence pyramid schemes. They are also more expensive to the cities than GKOs to the federal government because they carry no tax exemption and are inherently riskier than federal securities.

Housing Bonds

Hardly eligible to be called bonds at all, these “bonds” are rather a way to pre-pay for housing construction when, on the one hand, a large number of citizens do not have the money to pay for housing up front, and, on the other hand, construction companies do not have the working capital to carry them through the construction phase. As for lending directly to construction companies, it appears to be too risky for most investors. Also, the rates charged by commercial banks would make the prices for new housing prohibitively expensive for many people, whereas local governments can sell the housing to investors in their bonds at prices considerably lower than those charged by private developers.

Many municipalities perceive the shortage of housing as a major social problem, which explains why housing bond issues account for about half of the total number of issues. However, the proceeds of these bonds make up only about 15 percent of the total amount of local borrowing. These figures point to a very important limitation of these instruments: They are designed for people who wish to buy housing, not for a potentially broader number of people who wish to earn a financial return. A person wanting to get a market-based return on these instruments would have to engage in buying and selling housing, which involves an additional liquidity risk.

The other problem with these bonds is that their face value is linked to the price of a square meter of housing. In essence, an investor is buying his or her apartment meter by meter. Such an arrangement poses a significant commodity risk in the event that prices for construction materials go up (which they have done). Some municipalities have failed to properly index the bonds to construction price levels and have felt a severe financial squeeze as a result. As mortgage instruments are developed and legislation improves to allow recourse for nonpayment, cities are expected to stop providing housing for the bulk of the population, which will obviate most of the need for housing bonds.

There are other kinds of commodity-based instruments, similar to housing bonds. For example, some cities provide telephone lines and switching stations by engaging in this type of financing.

Arbitrage Bonds

These instruments are used by governments to achieve two main objectives: (1) acquiring risk-free financing for government programs, and (2) building public trust and confidence in the government's ability to pay back borrowed funds. These goals are accomplished by exploiting market inefficiencies that allow governments to borrow at a relatively low rate and then invest the proceeds into federal securities (most often, GKO's) that are out of reach of most individual investors. At maturity, the bonds are retired and arbitrage earnings are used for investment or operating expenses.

The heyday of these instruments was from 1994 through the first half of 1996, when the yields of federal short-term notes were very high and provided easy money for banks and institutional investors. As the rates dropped, GKO's became less attractive as a vehicle of arbitrage deals, which led to a substantial decrease in the use of arbitrage bonds by governments.

5.4 Legal Framework

The main legal document underpinning local and regional borrowing is the Constitution of the Russian Federation. Article 132 of the Constitution defines the right of local governments to independently adopt local budgets, and to set local taxes and fees. Borrowing is mentioned in the Constitution as one of the sources of local funds.

A more elaborate interpretation of the right to use borrowing is provided by the Law of the Russian Federation on Local Government, as well as the Law on Budget Rights, which specifically allows local governments to borrow for investment purposes.

The procedural aspects of placement and subsequent trading of government securities are regulated by the Securities section of the 1994 Civil Code. It provides some general definitions and guidelines. Other relevant laws are The Law of the Russian Federation on the Taxation of Securities Transactions, The Law on the Basics of the Tax System of the Russian Federation, and a number of Presidential directives, such as "On Measures to Impose State Regulation of Securities in the Russian Federation" and "On Selected Measures to Streamline Securities Market Operations." These directives regulate procedures for issuance, placement, service, and retirement of municipal debt.

The 1992 Ministry of Finance directive “On the Rules of Issuance and Registration of Securities on the Territory of the Russian Federation” requires all new issues to be described in a formal document (prospectus) and registered with the Ministry of Finance. This directive specifically mentions cities and raions as potential participants in the capital market, thus formalizing their authority to issue debt.

Empirical evidence suggests that there is no single law that issuers use as a basis for their actions. Some of them refer to the Constitution; others cite the law on the legislative and executive branches’ powers on the regional level; still others quote the Law on Local Government. Experts in this area, however, recommend the Constitution and the Law on Budget Rights as the basic legal ground for regional and local borrowing.

The current thinking about the direction that debt finance should take is reflected in the drafts of legislation aimed at further regulating the public securities market in Russia. One example is the draft of the Directive on the Issuance and Registration of Securities Issued by the Subjects of the Federation (regional governments) and Local Governments. This document gives the legislature the primary role in setting the amount of borrowing and in making decisions on specific bond issues. If passed, this measure would provide more legitimacy to local and regional borrowing, which is currently overwhelmingly under the control of the executive; and it would provide greater continuity of and responsibility for local and regional fiscal policy.

The draft also attempts to regulate the use of proceeds. According to the draft, the only legitimate use of long-term borrowing should be investment into revenue-generating or non-revenue-generating projects. It specifically forbids using the proceeds for current expenses.

5.5 “State Status” for Regional and Local Bonds: Tax Exemption and Implicit Federal Guarantee

From early 1992 to mid-1995, the Federal Securities Commission registered 83 regional and local bond issues. But as the popularity of debt finance grew, it also became clear that under the existing tax regime, sub-federal paper with no tax exemption was much less attractive to investors than other instruments, particularly GKO. Therefore all regional and local governments tried to secure a “state status” for their bonds, which would level the playing field for sub-federal and federal securities. They interpreted legal definitions of their status to mean that regional and local governments are bodies of executive state power on the local level and therefore their bonds must have a “state status.”

The years 1994 and 1995 saw a growing resistance on the part of the Ministry of Finance to granting the state status to sub-federal bond issues. One of the reasons, no doubt, was the possible tax base erosion; but the implicit federal guarantee of local borrowing was a much more serious concern. If a large number of regional and local governments were to default on their obligations, this would impose a considerable burden on the federal budget.

After initially revoking the state status for all sub-federal borrowing, the Ministry of Finance reinstated it for regional governments’ debt, which created an incentive for the regions to issue bonds on the part of local governments to finance local programs. Apparently, requests for tax exemption are still handled on a case-by-case basis, since this was one of the uncertainties facing Moscow’s bond issue in the first quarter of 1997.

Apart from these problems, the federal government does have the legal right to step in to remedy a local government's default. Article 126 of the Civil Code stipulates that the Russian Federation can assume obligations of sub-federal governments.

5.6 Overview of Sub-Federal Borrowing in 1996

As Table 5.1 below indicates, there are major differences among regions of Russia in their level of economic development and financial well-being. Moscow is vastly richer than any of the country's other cities. Although its 8.6 million officially registered residents make up only 6 percent of Russia's population, the city accounted for 24 percent of the country's tax revenues in 1996. It was the only one of Russia's 89 regions that ran a budget surplus; in addition, along with just nine other regions, Moscow was a net contributor to the federal budget. The average 1996 income per person in Moscow was US\$6,122, compared with a Russian average of US\$1,797. About US\$4.3 billion of foreign investments in Russia went to the capital—about two-thirds of the total.

Table 5.1 Economic Differences, by Region

	Moscow	Tyumen	St. Petersburg	Sverdlovsk	Nizhni Novgorod	Samara	Tatarstan	Chelyabinsk	Irkutsk	Krasnovarsk	Russia
Investor's rating*	1.0	1.7	2.1	2.4	2.5	2.6	2.9	2.9	3.4	3.6	
GRP [†] growth 1997, %	6.3	4.5	2.9	5.9	4.0	6.8	6.4	3.9	4.1	2.7	2.0
% of Russian GDP	10.9	8.6	3.2	4.2	2.6	3.3	2.8	2.3	2.7	2.8	
Population, m	8.6	3.2	4.8	4.7	3.7	3.3	3.8	3.7	2.8	5.1	148
Households with phones, %	50	15	39	19	18	14	12	15	11	12	19
Income per head 1996, US\$	6,122	4,033	2,155	1,599	1,211	1,586	1,280	1,350	1,915	1,865	1,797
Budget deficit [‡]	Surplus	0.7	23.0	4.2	0.8	1.9	8.3	2.0	4.0	5.3	6.2

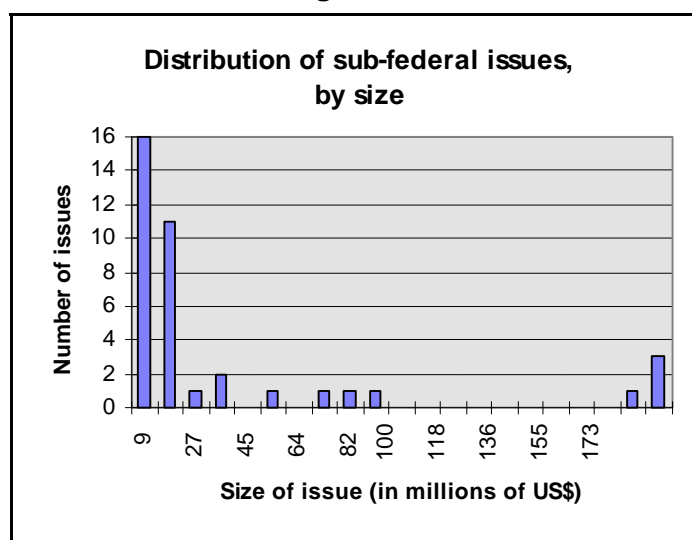
* 1=excellent, 5=lousy †Gross regional product ‡Percent of revenues

Source: *The Economist*, Vol. 344, No. 8033, p. 50.

Economic and financial disparity coupled with fragmented capital markets significantly limits the ability of provinces to raise needed capital. Not enough income is generated on their respective territories to support the secondary market, and even the primary market is often dominated by the local branches of Moscow banks, which have resources to handle the regional borrowing needs. On the other hand, with the exception of a few larger bond issuers, notably St. Petersburg, regional borrowing does not offer enough volume to get the large Moscow-based investors interested.

Figure 5.1¹ shows the double-humped distribution of sub-federal issues, which indicates that most cities use the proceeds to finance relatively small programs such as construction or completion of several apartment blocks. A much smaller number of cities issue substantially more debt for larger housing, infrastructure development, or social programs. Finally, at the other end of the spectrum, there is the city of St. Petersburg, which is using short-term borrowing to supplement its operating budget and has become considerably dependent on such borrowing since its first bond issue in 1995.

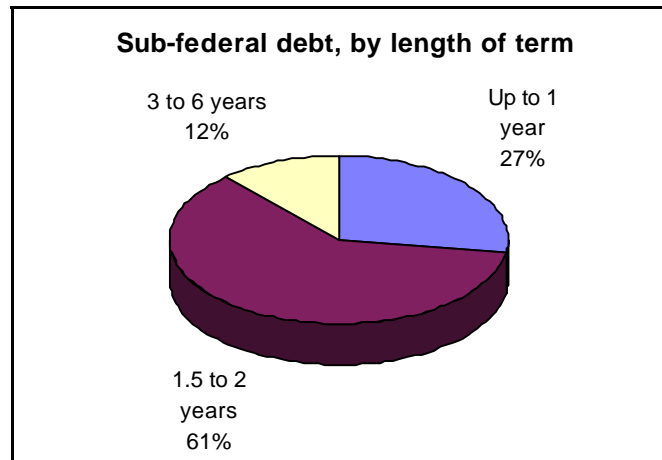
Figure 5.1



Although inflation and interest rates are declining, they remain high enough to discourage long-term borrowing. Political and economic risks are still significant enough to make investors wary of giving up their money for long periods of time. As a result, borrowing tends to be relatively short-term, although there is a clear tendency toward increasing term lengths. Figure 5.2 shows that most of the regional borrowing is for the term of less than two years. Short repayment schedules deny governments the possibility to spread the costs across longer periods of time, creating an upward pressure on the prices for commodities—such as housing—and services. In many instances, these higher prices have to be absorbed in part by governments themselves because, for political reasons, they cannot charge consumers the full costs.

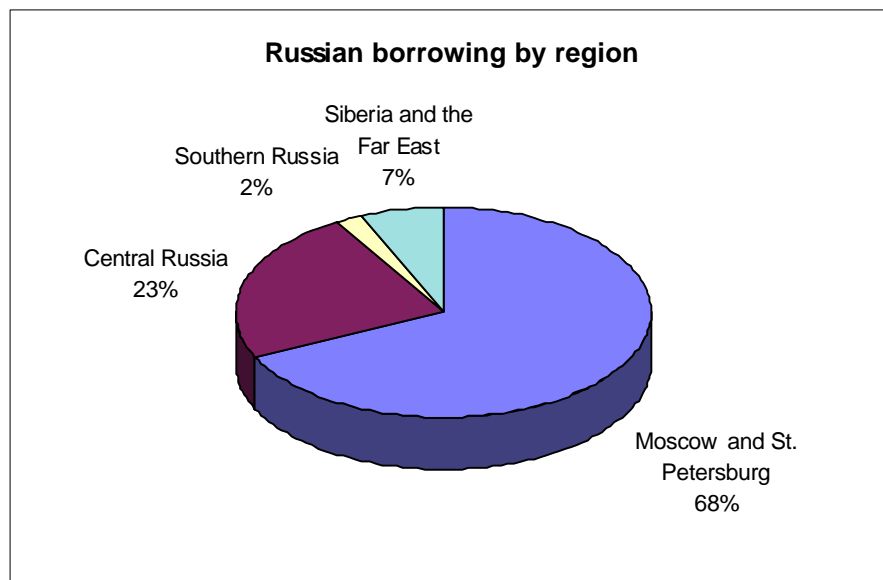
¹ All the graphs are based on information filed by cities and regions with the Ministry of Finance in 1996.

Figure 5.2



The geographical distribution of regional debt (Figure 5.3) shows that the market is dominated by securities issued by Russia's two largest cities. In fact, this share consists mostly of St. Petersburg, which has allowed debt to become an important part of its operating funds and which is hitting the market with its MKOs (short-term municipal obligations) every quarter. By contrast, the other regions have been just testing the water with demonstration issues, or using debt sporadically to finance more or less specific programs. No doubt, it is also a matter of being able to raise money on better terms, where Moscow and St. Petersburg clearly have an advantage because of their size, status, ability to offer more liquid collateral, and large number of financial institutions.

Figure 5.3



The yields of the bonds registered with the Ministry of Finance in 1996 were determined in the following ways:

- Indexing to the Central Bank rate (the majority of issues);
- Setting the redemption price equal to the commodity price (for housing bonds), creating an implicit return equal to the difference between the purchase price and the value of housing at redemption;
- Allowing prices (the size of discount) to be set by auction; or
- Using a fixed coupon (few issues).

1996 was a presidential election year in Russia, which meant a lot of uncertainty for financial markets. Yeltsin's health problems later in the year added to the volatility of interest rates. Generally, short-term interest rates were relatively high (over 80 percent), closely following the direction taken by GKO's. Compared with 1996, 1997 has been much more favorable for borrowing, with inflation down to about 15 percent and the Central Bank rate at 36 percent.

5.7 The Future of Russian Municipal Bonds

Russia's initial experience in local borrowing came at a difficult time of high inflation, falling gross domestic product (GDP), inadequate market infrastructure, and shortage of investment professionals. Given that in spite of all these problems local and regional governments have managed to tap private capital markets to some extent, there is little doubt that this hard-earned experience will pay off in the more stable financial environment that is currently settling in in Russia.

Moscow is clearly the leader in market development for local obligations, in terms of both the amount of borrowing and the sophistication of its financial infrastructure. This city has also received the benefit of hosting a large number of domestic and international financial experts, and it is home to branches of some of the world's largest investment banks, which have the capacity to handle large amounts of debt. This situation gives its government officials access to the best financial expertise and allows them to be more articulate in formulating the city's debt financing policy. For these reasons, Moscow is likely to become the model for other Russian cities that plan to use private capital markets to fund their investment programs.

The most notable change in the philosophy of borrowing has been that it is now seen as the most important source of money for capital investment projects. It is projected that in two to three years, the Moscow investment program will be 30 to 50 percent debt-financed. This is a drastic change from the current situation, in which most capital improvements are funded from the city's budget or federal grants.

The city is developing a debt policy that provides for a sizable but sustainable amount of outstanding debt, which will be maintained so as not to exceed a certain percentage of the city's revenues.

Types of Instruments

The choice of financial backing reflects the taxing powers of the city of Moscow and the revenue-generating nature of projects to be financed. Specifically, Moscow's debt will consist of:

- General obligation bonds;
- Limited general obligation bonds, with a particular revenue source earmarked as a repayment source for the bonds;
- Revenue bonds.

Use of Proceeds

The city of Moscow investment program specifies several types of projects to be financed by borrowing.

Renovation projects allow the city to keep about half of renovated space, which later can be sold or leased. Currently the city has 700 renovation contracts under way, and this activity is expected to increase. The completion period for such projects is one to two years.

Financing the completion of halted construction projects is another major use of proceeds that will allow the city to use the infrastructure already in place and to implement projects without additional zoning work. The projects that were frozen because of lack of financing were originally intended to provide 14 million square meters of space. Most of the sites (86 percent) are the property of the federal government, which raises the problem of subsequent ownership. The other potential problem is that most of these sites were planned years ago for industrial use and are still going to be completed as such, which may be contrary to Moscow's current needs.

City of Moscow development projects are long-term capital improvement programs that are spelled out in the General Development Plan of the city. These include renovations of the historical center of the city, construction of the "business downtown," and modification of the Moscow ring road. Here the city is counting on the partnership between public and private sectors in order to ensure sustainability of the projects.

Special projects will be considered in order to provide more balance to the debt portfolio, particularly shorter-term obligations. These projects will have to be relatively small and have a short payback period (up to a year).

While the city is justifiably concerned with the impact of its investments on economic development and job growth, it should probably limit its role to the one of provider of essential services, facilitator, and regulator of business activities on its territory. In the materials that describe the city's investment program, references are repeatedly made to "rejuvenation of the city's industry," "boosting of science and high technology," and even "reconstruction of the ZIL and Moskvich automobile giants." While industrial revenue bonds will undoubtedly play an important and positive role in Moscow's development, the city should exercise caution in underwriting projects that are purely commercial in nature. The bailout of the two inefficient, uncompetitive, and virtually bankrupt auto factories could end up as a financial disaster that the city might be well advised to stay out of.

Credit Ratings

For Moscow and St. Petersburg, assignment of a credit rating became a major milestone in the two cities' quest to access Eurobond markets for longer-term funds. Moody's rated Moscow's US\$500 million, 3-year Eurobond issue as Ba2, and Standard & Poor's assigned it a BB-. St. Petersburg was rated Ba3/BB- on its US\$300 million issue. These ratings were constrained by the Russian Federation's existing Ba2 foreign currency rating. The sovereign ceiling represents the highest foreign-debt credit rating that a borrower in the country can receive. According to both rating agencies, Moscow's credit rating might have been higher, particularly since the city is actually debt free. Although the rating was done for the purposes of international borrowing, the fact that the city got such a good rating opens the door to increasing offerings of longer-maturity ruble bonds.

5.8 Conclusion

Currently the market for regional and municipal securities in Russia is obviously underdeveloped, but is expected to make dramatic advances in the next few years. Debt issues in the provinces are starting to offer yields comparable with federal obligations, and governments have gone a long way toward providing adequate backing to their securities. In the past, regional investors put their money into federal obligations. Now they are facing a viable alternative offered by regional securities. According to the Moscow government's Municipal Borrowing Committee, 1997 is likely to see investors pull about 10 percent of their funds out of GKO's and put them into regional obligations.

6

South Africa: Steps Toward Establishment of an Active Post-Apartheid Municipal Credit Market

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6.1 Introduction

Local governments in South Africa face a large investment challenge. The investment goals laid out in the document *Towards a National Infrastructure Investment Framework* imply that, even under a relatively conservative scenario in which the backlog of basic urban investment needs is satisfied over a 7- to 10-year period, municipal investment will have to climb by 10 percent in real terms in 1997/98 and more than 17 percent, 16 percent, and 12 percent, respectively, in the years thereafter, before the rate of growth subsides below 10 percent.¹ The *National Infrastructure Investment Framework* projects that approximately R5 billion per year of new borrowing by local authorities will be necessary to meet the municipal investment objectives contained in the conservative investment scenario.² Much of this investment—roughly half—will have to be financed by local authorities themselves.

The investment needs found in South Africa create several challenges for financing local capital investment. Local investment needs are highly redistributive. The populations obtaining new access to infrastructure networks will be primarily low-income households, which will be hard pressed to meet the government's goals of having users pay for the full operating costs of services, even when infrastructure standards are adjusted to make service provision more affordable.

Municipal investment needs are also highly concentrated. Government has assigned high priority to providing rural villages with basic infrastructure, but the volume of anticipated municipal investment, as well as the volume of private credit and other forms of private financing that is needed, will be highly concentrated in the larger urban areas.

Local authorities will be able to finance a portion of their own-source investment requirements from restructured Regional Services Council (RSC) levies paid at the metropolitan level, from local authorities' reserves now held in Capital Development Funds, and from asset sales. They will benefit from some private-sector equity investments as a result of privatization of municipal infrastructure projects. As the *Framework* notes, however, "it is envisaged that most [of the financing] will have to be borrowed from public and private intermediaries." Under government policy guidelines, even the public intermediaries providing credit to municipalities will have to

¹ Ministry in the Office of the President, *Towards a National Infrastructure Investment Framework* (March 1996).

² At the time of the study, US\$1.00 = South African Rand 4.40, approximately.

raise the bulk of their financing by borrowing from the private market or from multilateral lending agencies. Very little of the government's fiscal revenues have been targeted for onlending to municipal authorities.³

6.2 Interest of USAID/South Africa in Municipal Bond Market Development

Recognizing the enormous need for investment and development in the municipal sector, the United States Agency for International Development (USAID) has provided technical support to the Republic of South Africa to assist in implementing its infrastructure finance policy since the Government of National Unity came to power in 1994. This paper is adapted from a report written in connection with one instance of technical assistance.⁴ The assignment, carried out in March 1997, was aimed at identifying principal obstacles to expanding municipal credit market activity in South Africa, and identifying options for USAID involvement in strengthening the market.

USAID carries out a range of housing and urban development activities in South Africa under the umbrella of the mission's Strategic Objective 6: "Increased access to environmentally sustainable housing and urban services for the historically disadvantaged population (HDP)." Activities under this objective focus on:

- Improving the environment for the development and implementation of a policy agenda for increasing access to housing and urban services for the HDP.
-
- Ensuring that previously ineligible households, developers, builders, and municipal service providers obtain access to credit for housing and urban services.
-
- Increasing the noncredit forms of assistance that are made available by participating institutions to HDPs for obtaining access to housing and urban services.

6.3 The Municipal Credit Market in South Africa

South Africa appears to have a vigorous history of municipal lending; however, this history is deceptive. A relatively strong and active municipal bond market did previously exist. There is also a substantial track record of commercial bank lending to local authorities, both for investment and for cash-flow purposes. However, the rules under which the municipal credit market formerly operated have now been changed (see below). As a result, over the past two years, private-sector, long-term lending to local governments has been declining, to the point

³ The principal exception is the callable capital of the Development Bank of Southern Africa (DBSA), which can potentially be used for financing municipal infrastructure. As of year-end 1996, DBSA had the right to draw on R1.8 billion of government equity capital. This drawing right was raised in 1997 to a total of R5 billion. However, current policy is to not actually call the capital.

⁴ George E. Peterson and Priscilla M. Phelps, *Municipal Credit Enhancement in South Africa: Strategic Opportunities for USAID*, written for USAID/South Africa under the Environmental Policy and Institutional Strengthening Indefinite Quantity Contract (EPIQ) of the Center for the Environment/USAID, May 1997.

private institutions generally either are not supplying new long-term credit to local authorities or have substantially reduced their lending and municipal bond purchases. Currently, there is considerable difference of opinion among market participants as to how the “old” South African municipal credit market does and should relate to today’s market.

The “Old” Municipal Credit Market

According to figures from the South Africa Reserve Bank, South African investors hold approximately R9 billion (+/- US\$2.1 billion) of local authority bonded debt. Roughly two-thirds of this amount is held by the private nonbanking sector, primarily pension funds and insurance companies; governmental bodies hold most of the rest. Total “local sector” debt, including bank and parastatal loans to municipalities and the bonded debt of other subnational authorities, such as water boards, is considerably larger—in the vicinity of R21 billion. Three of the private financial institutions interviewed as part of this study reported holding total local sector debt of more than R3 billion each.

In view of the magnitude of local government debt outstanding, observers sometimes speak of a need to “revive” or “reactivate” the municipal credit market. Previous municipal lending, however, took place under a special set of circumstances that will not be repeated. Most of the local authority debt now outstanding was issued as part of a prescribed investment regime. Financial institutions were required to invest designated percentages of their portfolios in government debt, either national government debt or local government debt. In this environment, municipal debt was an attractive investment. It carried a moderate interest-rate premium over central government debt. Yet local government debt was widely viewed as nearly risk free. Municipal bonds were issued solely by well-funded white local authorities. Municipal bonds and municipal loans also were widely viewed as “guaranteed” by the national government, which would come to the aid of an issuing authority in the event it encountered financial trouble. The guarantees were implicit but assumed to be valid by most institutional purchasers.

Moreover, white local authorities operated conservatively. They were endowed with ample resource bases, and during much of the apartheid era, were required by government regulations to participate in a forced savings program, which further strengthened their balance sheets. Under these circumstances, white local authorities could count on buyers for whatever debt they chose or were legally entitled to issue.

Municipal debt during the apartheid era in fact proved to be a very low-risk investment. Over the 18-year history of the Local Authorities Loan Fund (LALF), up to 1995, there were no loan defaults. Defaults on municipal bonds also were nil.

The Current Municipal Credit Market

Today’s municipal credit market operates under a very different set of conditions.

- The domestic financial sector has been liberalized. There is no government-prescribed allocation of private-sector credit to the municipal sector or to the public sector at large, thus removing the “automatic” demand for local authority debt.
- The government has clearly announced that it will **not** guarantee local authority debt. It has stated that no guarantees attach to “old” municipal debt either.

- Perceptions of the underlying financial risk involved in municipal debt have changed drastically. Amalgamation of former black local authorities with former white local authorities has weakened the fiscal base of local governments that have private-sector debt outstanding.

There have been signs of increasing credit risk. As noted, until June of 1995, the Local Authority Loans Fund had an 18-year history of no defaults. Since that time, defaults have accelerated. By December 1996, 48 of the 425 local authority borrowers participating in LALF were in default. In the 18 months ending December 1996, payments in arrears at LALF climbed from R25,000 to R9,100,000. Some large private institutional holders of local authority debt also reported to us that missed payments from local authorities had escalated dramatically in the final quarter of 1996.

At the same time, actual default experience in the local authority sector remains relatively low, especially for private lenders. This is reflected in the BIS (Bank of International Settlement) ratio that is applied by bank regulators to local authority loans in calculating capital adequacy ratios. Local authority loans carry only a 10 percent additional risk weighting over loans to central government, which is among the lowest risk ratings for the local government sector anywhere in the world. It is common to find BIS risk weightings of 80 percent and 100 percent for local authority debt, for example, in Eastern Europe.

Some of the uncertainty about the municipal sector is inevitable during this period of fiscal transition. Some of this uncertainty will diminish as the municipalities and their lenders adapt to the changes that have taken place. Among the factors contributing to the uncertainty are the following:

- The future revenue structure of local authorities has not been fully clarified, nor has the sector's complete range of expenditure obligations.
- Quality information on local authority financial condition is generally not available. Local authorities typically are unable to supply it. South African credit rating agencies to date have rated only a small number of municipal authorities. And information that the government obtains on local financial condition, as a result of its own monitoring, is not released to the public.
- Financial institutions holding local government debt generally do not actively monitor individual authorities' financial condition. Many of these institutions purchased local authority debt expecting that it would be a "low maintenance" holding.
- The legal status of the outstanding local authority debt is often unclear. Many local authorities that have borrowed in the past have been amalgamated with other authorities. The restructured authorities are operating under interim fiscal and legal structures, for which basic legal questions—such as the priority of claims in the case of insolvency, the legal steps available to enforce debt payment, or the procedures to be followed in the case of municipal "bankruptcy"—are presently unresolved and likely to be the subject of future national and provincial legislation.

As a result, a number of the current institutional holders of local authority debt can be characterized as “reluctant holders.” They would sell their holdings if there were a secondary market or if there were buyers at what they regard as an acceptable discounted price.

This overhang of outstanding local authority debt connects the “old” local authority credit market with the “new” market. Because a relatively small number of financial institutions, and an even smaller number of different financial groups, historically have dominated the municipal credit market as well as the financial sector in general, the institutions now holding “old” local authority debt will have to play a significant role in providing “new” credit to local authorities. This makes it impossible to simply walk away from the “old” debt while designing a new municipal credit system for the new South Africa.

6.4 Characteristics and Condition of the Municipal Sector

South Africa in 1996 had 821 recognized municipal authorities, consisting of 30 Metropolitan Councils and Substructures, 513 Transitional Councils, and 278 District Councils and Rural Councils.⁵

The financial weight of local budgets is highly concentrated in the larger urban regions. The 30 Metropolitan Councils and Substructures contain 13 million people (some 30 percent of the population) but account for well more than 50 percent of total local government expenditures. In contrast, the 278 District Councils and Rural Councils account for less than 6 percent of local government spending.

Behind the change in perceived municipal credit risk lies the fundamental change in municipal finances that has accompanied amalgamation of the formerly black and white townships (see Table 6.1). Relative to the demography of the former white townships, which were the sole users of long-term private-sector credits, amalgamation has expanded the total municipal population and lowered average incomes and tax collection capacity. At the same time, it has vastly increased credit and capital financing needs by bringing into the amalgamated towns large populations that do not have access to infrastructure services.

The weakened fiscal capacity of towns (relative to former white local authorities) has been compounded by difficulties in local collections of service fees and rates. During the apartheid era, rent and service-payment strikes were one of the most successful weapons township inhabitants used to protest government policy. The habit of nonpayment has carried over to the newly amalgamated local authorities, despite the “Masakhane Campaign,” which is a national initiative to educate households in the importance of paying service fees to finance local governments’ budgets.

⁵ The number of “local authorities” sometimes is reported as modestly larger because of the inclusion of other kinds of local governmental bodies. The figures reported here are based on the number of councils and substructures reporting their budgets to the Ministry of Finance, as required by law. Due to jurisdictional reorganization, the number of councils is still in flux.

Table 6.1 Effect of Amalgamation on Municipal Demography and Fiscal Capacity

Town	Population^a	Annual Income per Capita^a
Bloemfontein	178,132	R7,188
Mangan	123,477	2,064
Amalgamated Total	301,609	5,090
<i>Percent Change from Bloemfontein</i>	<i>+59.1</i>	<i>-29.2</i>
Kroonstad	37,640	R6,756
Maokeng	71,441	1,812
Amalgamated Total	109,081	3,518
<i>Percent Change from Kroonstad</i>	<i>+189.4</i>	<i>-47.9</i>
Warmbad	6,696	6,720
Bela-Bela	11,983	1,680
Amalgamated Total	18,679	3,487
<i>Percent Change from Warmbad</i>	<i>+178.8</i>	<i>-48.1</i>

^aPopulation and income data are for 1991.

Source: Barry M. Jackson and Mike W. Marler, *Infrastructure Needs in South Africa's Towns* (paper presented at conference of the Institution of Municipal Engineers of South Africa [IMIESA], October 1996).

6.5 Unique Characteristics of the South African Municipal Sector

Three features set South Africa's municipal sector apart from the structure of local government capital financing commonly found in other parts of the world.

Municipalities' Reliance on Own-Source Revenues

In South Africa, roughly 90 percent of municipal revenues consists of "own source" revenues, raised at the local level. This situation implies much less use of intergovernmental grants (IGG) and tax sharing than in most countries, whether developing or developed. Further, intergovernmental grants from central government have been declining in real terms from the levels achieved at the beginning of the Reconstruction and Development Programme (RDP).

South Africa does not at present have a matching grant structure, under which local authorities of limited fiscal capacity can have their own-source revenues or borrowing matched by intergovernmental capital grants. Current practice, with rare exceptions, is to finance capital projects either entirely through government grants or entirely through local authorities' own revenue sources supplemented by near-market-rate borrowing. Given the difficulty of obtaining intermediate-term credit for capital purposes, many municipalities are now financing investment from short-term lines of credit at local bank branches.

Importance of Service Revenues in Local Budgets

South African municipalities are almost unique in the extent to which their budgets are financed by fees for services. More than 60 percent of gross municipal recurring revenue comes from fees for electricity, water, sewerage, and refuse collection. Electricity fees alone account for more than 40 percent of gross municipal revenues nationwide. The share of service fees in *net* local authority revenue is less, of course, since purchases of bulk electricity and bulk water from regional suppliers are also among the largest expenditure items.

Local authority income from local taxes is correspondingly modest. Revenues from property taxes—by far the single largest local tax source—generate less than 20 percent of aggregate municipal income.

Nature of Future Municipal Capital Investment

Municipal investment now and in the intermediate-term future will be overwhelmingly concentrated on extending basic infrastructure access to populations previously excluded from service coverage. According to the *Municipal Infrastructure Investment Framework*, the priority sectoral claims on municipal investment will be for roads and stormwater drainage, sanitation, commuter transportation, and water distribution, in declining size of expected investment. Some of these investments, such as spending on roads and commuter transportation, however, are highly concentrated in the large metropolitan areas, and likely to be financed from metropolitan-scale revenue sources and/or private investment. For most local authorities, expansion of water and wastewater systems to reach presently unserved populations is the most urgent investment priority.

6.6 Government Policy on Local Capital Financing

Local authorities in South Africa differ significantly in financial condition, and as a result in the kind of capital financing strategy that is likely to be appropriate for each class of authority, based on its financial strength.

At this point, the greatest number of local authorities (perhaps 600 to 650) could be classified as financially weak. These municipalities are unable to contribute significant amounts of capital financing toward meeting their infrastructure needs. Since the end of apartheid, varieties of government programs have been formulated to provide grant financing or direct government construction of essential infrastructure projects in rural areas and poorer communities. Within the water sector, for example, the Department of Water Affairs and Forestry has clearly enunciated policy guidelines that target grant assistance to small and poor communities, while requiring that better-off local authorities tap the private sector for financing at market rates.

A smaller number of local authorities (perhaps 100 to 150) can afford to pay for part of their own capital expenditures. In these cases, the municipalities' own-source revenues or private-sector borrowing could be augmented with matching capital subsidies of some type from the public sector. For these municipalities, the government has embraced the principles of co-financing. One objective is to introduce municipalities in this tier to the discipline and terms of private-market financing. These municipalities will also be target clients of the Development Bank of Southern Africa (DBSA). As part of its institutional transformation, DBSA has announced that it will seek out opportunities for co-financing municipal credits with the private

sector. It has also been given the mission of serving as a wholesale infrastructure development finance institution.

A still smaller universe of local governments (25 to 50), most of them belonging to the larger urban areas, are in significantly stronger financial condition. They can afford to pay for most local capital projects from their own resources. The government is encouraging full private-sector financing for municipalities in this class. It has challenged the private financial market to come up with new financing instruments that can mobilize market-rate funds on behalf of the larger metropolitan areas and municipalities whose finances make them creditworthy borrowers. It has announced that it will not provide government subsidies to borrowers that can access the private credit market without subsidy. The government also has encouraged local infrastructure privatization and public-private infrastructure partnerships as ways to access private capital for municipalities in this highest tier.

6.7 Areas for Municipal Finance Market Development

The overall objective of municipal finance market development should be to increase the **system's** capacity for efficient infrastructure financing. Private financing does not serve a public purpose if only certain high-quality projects are privately financed, and there is neither an increase in the total capital available for infrastructure investment nor greater efficiency in project design and operations. Four obstacles to private-sector municipal credit market development are apparent in South Africa: (1) the lack of risk assessment capacity for the municipal sector, (2) the need for strategies to reduce credit risk, (3) the need for a secondary market or other mechanisms to reduce liquidity risk, and (4) the need to expand private sector involvement in municipal finance.

Improving Municipal Credit Risk Assessment

The capacity to accurately identify investors' exposure to credit risk through municipal bonds and other credit instruments issued by local authorities is a prerequisite for making the capital financing system successful as well as boosting the flow of private capital to the municipal credit market.

Unfortunately, the financial risks emerging in the new municipal sector are difficult to appraise. The future intergovernmental financing system has yet to be determined. The ability of local governments to increase collections for rates and fees is uncertain as well.

These uncertainties are exacerbated by the limited availability of municipal financial information. Published municipal financial reports are released too late to be used for financial monitoring. Information from public sources, such as "Project Liquidity"⁶ and DBSA, is treated as confidential.

⁶ "Project Liquidity" was launched in September 1996 by a joint meeting of local government and finance ministers and provincial MECs (Members of the Executive Council of each province). Teams of financial experts have been established in each province to visit all municipalities reporting cash-flow problems, to conduct detailed assessments, to make recommendations for action, and to otherwise intervene as necessary. (Source: online South African newspaper, www.woza.co.za/budget97)

In this environment, proactive credit analysis and financial monitoring of local financial conditions by lenders becomes imperative. Unfortunately, most lenders have been accustomed to treating municipal bonds as long-term holdings that do not require surveillance, so specialized credit-rating and surveillance capacity within financial institutions is limited.

These factors create an opportunity for organizations that specialize in municipal credit ratings and municipal financial surveillance. South Africa has two credit rating agencies planning expanded coverage of the municipal sector—the International Bank Credit Analyst (IBCA), Europe's leading international credit rating agency; and Duff & Phelps, a leading U.S. credit-rating agency. IBCA formally was rating only five or six local authorities at the time of this analysis. Duff & Phelps was just preparing for entry into the sector.

Both organizations, however, acknowledge that municipal ratings will only gradually acquire market impact. It is likely to require some two years to assemble enough information on municipal finances, and to have a long enough period of observation concerning municipal financial risk in the new South Africa, to formally rate a significant part of the local authority universe beyond the top tier of local governments. Meanwhile, IBCA has joined with the Infrastructure Finance Corporation (INCA) in an initiative to create a purely private-sector financial intermediary to support onlending to the municipal sector.

Reducing Municipal Credit Risk

In addition to accurately measuring credit risk, private-sector suppliers of municipal credit have a strong interest in **reducing** the risks of municipal lending. Reducing credit risk in the municipal market is perhaps the most natural definition of “credit enhancement.” Potential approaches that could be considered are the following.

Reduction in Project Risk at the Local Level

Essentially all municipal bonds in South Africa, as well as long-term bank loans, now represent balance-sheet borrowing or general obligation borrowing, secured by a general claim on the assets of the borrowing municipality. The logical next steps in credit market development would appear to be (1) project finance, where utility revenues are “ring fenced” and dedicated as bond security; and (2) the use of municipal revenue bonds, secured by the revenue stream produced by a specific service, such as water provision or trash collection (reinforced, if needed, by a general obligation claim on all of the municipality's revenues and assets).

Introducing the practice of specific property collateral with immediate market value to support municipal bonds or municipal loans could reduce bond and loan risk. Specific collateral would also reduce credit risk, by reducing the uncertainty as to the legal process and timeliness of settling general obligation claims. Although South African local authorities do not have as wide a range of assets as municipalities in some other parts of the world, many do hold valuable parcels of municipal land and other assets that have immediate market value.

Project risk can also be reduced by better financial structuring of loan deals, including the creation of local reserve funds that provide financial protection for lenders. Reserve funds are becoming common practice in financing that supports privatization deals, and can be carried over to straight municipal borrowing.

Government Guarantees

Government guarantees reduce (or nearly eliminate) lenders' risk in municipal borrowing. From a developmental perspective, government guarantees typically create perverse efficiency incentives. They encourage lenders to dispense with project review and even to ignore local financial conditions. As long as a loan is adequately covered by central government guarantee commitments, the lender has no reason to limit its lending to economically feasible projects. The South African government has announced that it will provide local authorities with loan guarantees only under the most exceptional circumstances, largely out of concern for the contingent liabilities that loan guarantees create for the fiscus.

Bond Insurance

There presently is not a large enough pool of municipal debt issues in the South African market to make pure bond insurance feasible without public subsidy. Moreover, the "risks" of municipal bonds have as much to do with uncertainty about future fiscal rules, the future legal environment, and the future political situation as they do with known and measurable financial risks. This situation makes the pricing of insurance extremely difficult—if not impossible—in the intermediate term. The payoff to municipalities from buying insurance is also highly uncertain. At present, market interest rates charged to borrowers are not greatly influenced by credit rating differences. It therefore is difficult to imagine that bond insurance, whose principal impact on interest rates is realized indirectly through better credit ratings, could be cost effective to issuers without substantial subsidy.

In the South African context, the assistance that bond insurers provide in reducing local project risk and supplying monitoring and surveillance is probably more important to market development than the pure insurance component.

Co-Financing with Parastatal Authorities

Private-sector lenders can reduce their own credit risk by sharing this risk with parastatal or public sector lenders. In the case of South Africa, the logical partner for co-financing of this kind is DBSA. Further credit enhancement is provided to the private lender if the parastatal lender such as DBSA is willing to take a junior or subordinated debt position. In this case, the first funds at risk in case of a revenue shortfall are the parastatal's.

DBSA as a co-financing partner is likely to bring additional forms of risk reduction, including better information about and management of local projects. It also provides some political protection for a project and an indirect form of partial insurance against political or legal risks.

Lending Through a Private-Sector Intermediary

Properly structured, a private intermediary facility can combine almost all of the risk-enhancement features discussed in this section. It can afford to create a specialized capacity in municipal credit risk assessment, like a credit-rating agency. It can carry out active surveillance of municipal borrowers, and intervene at an early stage to minimize repercussions from signs of financial weakness. It can enter into co-financing agreements with a parastatal lender, when and if appropriate. It can, and should, work with municipal borrowers to help them structure local investment projects in a way that lessens financial risk.

Reducing Liquidity Risk

Liquidity risk, that is, the timing uncertainty associated with the sale of securities in the secondary market, is a form of municipal credit risk that has great importance to South African investors. As a result of changes in the South African investment environment, liquidity risk is now reported to be a major deterrent to the purchase of municipal bonds.

Traditionally, South African lenders to the municipal sector did not worry greatly about liquidity risk. Pension funds and insurance companies purchased municipal bonds to match long-term liabilities (such as fixed pension payment obligations). In this environment, they could afford to be “buy and hold” participants in the municipal market, generally holding bonds until they matured.

Several factors have combined to increase the demand for liquidity in the new municipal credit market. Defined-contribution pension plans are swiftly displacing defined-benefit plans. This means that pension fund managers have to make sure not only that they can cover defined payment obligations, but also that they can compete with other pension funds on the basis of returns. More importantly, credit risk has increased in the municipal market, as discussed earlier. Without a secondary market in municipal bonds, holders have no way to trade out of a position, even if they accurately identify that a municipality’s financial position is deteriorating. These factors increase the importance of liquidity, because investment managers want to be able to sell when they think the market dictates selling.

The small size of municipal bond issues in South Africa is one major obstacle to creating liquidity in the market. The volume of trading in most bonds is insufficient to result in a liquid market. The alternative is designating a market-maker to buy back bonds from current holders, and resell them on the secondary market. Except in the case of government issuers or the very largest of the parastatal entities, such as Eskom (electric utility), an issuing institution will need to either serve as its own market-maker or pay another financial institution to perform this service. Rand Water is a large utility that serves as its own market-maker.

Almost all of the local authority bond issues are too small to trade naturally. Even those municipal bond issues listed on the Johannesburg Stock Exchange rarely trade.

An intermediary institution can potentially overcome the scale problem by pooling demands for financing and financing them through a single large bond issue. The intermediary has a much better chance of achieving the size threshold of tradability than does an individual issuer. This is the principle behind municipal bond banks and specialized municipal banks of the kind found throughout Western Europe and North America. Financial experts interviewed by the team placed the minimum threshold for practical liquidity in South Africa at anywhere between R500 million and R5 billion of aggregate bond value by an issuer.

Listing on the stock exchange is another requirement for liquidity. Although not sufficient to generate a true secondary market, listing on the stock exchange is considered a necessary condition for tradability.

Expanding the Role of the Private Sector

Only two private intermediaries for infrastructure finance were found to be operating in South Africa at the time of this analysis. Those are the South African Infrastructure Fund (SAIF) and the INCA.

SAIF, with a fund term of 15 years and initial capital in excess of R693 million, makes equity investments in infrastructure projects defined to include the environment (water, waste, sanitation, and sewerage), energy, telecommunications, ports and harbors, pipelines, toll roads, and transport sectors. For specific projects, the fund may assist in raising concessionary co-financing from multi- and bilateral agencies. Founding members include a number of major domestic pension funds, life insurance firms, and Standard Bank of South Africa, which sponsored the fund. The fund had made no funding commitments but was actively investigating possible municipal infrastructure projects at the time of this report.

INCA is a debt fund for infrastructure loans, whose target clientele includes local authorities, parastatal bodies and public utilities, district councils, provinces, private firms involved in local infrastructure development, and financial institutions of various kinds. Equity investors who initially contributed a total of R50 million included First National Bank (FNB), Southern Life Association Limited, Msele Financial Holdings Limited, South African Mutual Life Assurance Society, the Commonwealth Development Corporation (a British development finance agency), and DEG (a German development agency).

The company will raise debt through the South African capital markets by issuing two classes of bonds: senior bonds and junior bonds, each with various terms up to 15 years. The first sale of senior bonds, in the amount of R500 million (about \$120 million) took place in February 1997. Total senior debt is authorized up to R1.2 billion and an additional R200 million of junior debt is expected to be raised. The organization has received an AA- credit rating from IBCA.

For investors, INCA is structured to lessen risks in the existing municipal debt market, including (1) credit risk—by developing its own credit model that it will use to evaluate projects and allocate risk within its portfolio; (2) the lack of market-based credit enhancements—by its capital structure and its risk-management techniques; and (3) liquidity risk of municipal debt—through the use of a market-making agreement with FNB. INCA hopes later to create a program to purchase, enhance, and pool outstanding municipal debt that is not now being traded, in order to also address liquidity problems with the outstanding debt.

INCA helps borrowers overcome the high transaction costs associated with raising funds, especially bonds, by raising a single pool from which loans will be made to several borrowers. And it should lower the interest cost of capital to borrowers due to the credit enhancements built into the structure.

6.8 Assistance Options for USAID

From this review of obstacles and opportunities for private-sector financing of municipal credit, three potential roles were identified for USAID to play:

- Strengthening credit flows to the mid-level local authorities by providing credit to DBSA for onlending to municipalities at modestly subsidized rates.

- Strengthening the inflow of privatization capital to the municipal infrastructure sector by supporting the efforts of DBSA or private-sector entities to participate in privatizations of water and wastewater systems or other basic municipal infrastructure services.
- Strengthening the purely private-sector system for lending to the most credit-worthy local authorities by supporting a private-sector intermediary that specializes in municipal credits.

Each of these options was seen as being potentially valuable in helping to develop South Africa's municipal infrastructure financing system, consistent with the government's overall capital financing strategy. However, USAID's comparative advantage is seen as helping to develop South Africa's **private-sector** financing capacity. This means working with private-sector institutions that potentially can finance significant portions of Tier 1 local authorities' investment needs in the short run, while setting in motion a system that can graduate a greater number of Tier 2 local authorities to the private credit market over the intermediate term.

Zimbabwe: Expanding Municipal Bond Activity by Increasing Market Incentives in the System

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7.1 Introduction

The question of how Zimbabwe's municipal governments (known as urban councils or urban local authorities) can gain access to expanded financial resources for capital investment is repeatedly being asked in Zimbabwe today. Urban councils have a critical need for capital funds to respond to citizens' demands for new and upgraded municipal infrastructure. And as the traditional sources of funds for these purposes—central government funds and donor loans—decline relative to the ever-expanding need for investment, the understanding has grown that new, more sustainable sources of financing are required.

Clearly the most sustainable approach for the long term would be to raise capital funds through the Zimbabwean financial markets. This approach has successfully been used to a limited extent in Zimbabwe in the past. But what will it take to expand this avenue to a larger group of urban councils? And what constraints stand in the way of expanded market mechanisms being implemented in the near future? This article is based on a report¹ prepared for the United States Agency for International Development (USAID) that was intended to address these questions and to identify the specific resources that are currently available and that can help make these measures a success, as well as to identify potential roles for USAID.

The report was prepared following a review of extensive written material and numerous interviews held in Zimbabwe in the spring of 1997. The finding of the report is that there is great enthusiasm in both the public and the private sector for the idea of expanded financial market access for urban councils. At the same time, there is some skepticism about the feasibility of this approach under current conditions—including macroeconomic and institutional conditions in the country as a whole, and financial conditions at the municipal level. Developing an expanded municipal finance market will require bringing together both the enthusiasts and the skeptics, in order to design options that respond to both.

Enormous resources exist that can contribute to the success of an expanded system. At the same time, a number of constraints exist that will need to be overcome. The recommendation of the report is that Zimbabwe should proceed energetically with the development of an expanded system, by organizing a joint public-private effort to draw in the expertise needed, and largely already available, to carry out this very important effort.

¹ Priscilla M. Phelps, *Expanding Municipal Finance in Zimbabwe: Recommendations for Addressing Current Constraints* (Research Triangle Park, NC: Research Triangle Institute, September 12, 1997).

7.2 The Relevance of Municipal Finance to Zimbabwe's Development Agenda

Around the world, the impact of urban growth, and cities' related need for financial resources, is gaining increasing prominence in national development agendas. Cities contribute to national development in a number of ways. As a result, local governments are being recognized as important players in the national development agendas, and the capital constraint that they frequently confront is being recognized as a critical national policy issue that must be addressed if a country's economy is to thrive. How these issues are being addressed in Zimbabwe is discussed below.

In the past two decades, Zimbabwe has experienced both urbanization and relatively rapid population growth. Urban population has grown from less than 20 percent of total population in 1975 to 31 percent in 1995 (and is forecast to reach 36 percent in 2000), while the national population increased from 6,143,000 in 1975 to 10,413,000 in 1995.

Around the world, the expectations and demands placed on local governments are growing. While people are demanding more accountability in the delivery of services in return for the taxes and fees they pay, national authorities are delegating more responsibilities to the local level in order to attain fiscal balance in the central government.

In Zimbabwe, urban local authorities (urban councils) carry out a range of responsibilities that is broader than that of many other local governments internationally. It includes lighting, street paving, street cleaning, and parks maintenance as well as water, sanitation, solid waste management, housing, education, and health care. Urban councils also operate a number of enterprises, including beer halls and farms.

The desire for national economic growth puts pressure on cities and also fuels the demand for urban investment capital, since in economies at every development stage, economic activity depends on adequate investment in water, power, sanitation, roads, and other forms of infrastructure.

In Zimbabwe, new urban investment is being sought from local governments, as this paper discusses, as well as from the private sector. Urban council enterprises, in particular, are considered candidates for commercialization or privatization, as they have become less competitive and profitable over time, and in a number of cases create a drain on urban council resources. Basic municipal services are also privatization candidates. Some core services—such as solid waste management—have already been privatized, and others, including water facilities, are being evaluated by certain urban councils as potential candidates for privatization, especially where they are well-run and located in larger urban centers.

Municipalities also have a role to play in encouraging the entry of capital from international sources and helping to integrate the country into the global financial system. International investors seek investment opportunities that will provide returns at or above the market rate. In Zimbabwe, as in most developing countries, these opportunities may be found in the public sector, as well as the private sector, and there is a backlog of these investment opportunities.

The Zimbabwean financial sector is very interested in helping to develop a municipal finance system. As well, it is in the interest of Zimbabwe to ensure that the urban councils and the private sector set high standards in municipal finance that conform to international investment practices, even if at present, investments will be made only from domestic sources.

Private financial mechanisms designed for investing in municipal infrastructure take a number of forms worldwide, and all have potential relevance for Zimbabwe. When the borrower is a local government entity, the range of options generally includes (1) loans made by banks or by special-purpose financial intermediaries (public or private), (2) municipal bonds issued through the capital market, or (3) hybrid models where loans are obtained from market intermediaries that themselves issue bonds in the capital market.² Privatization of municipal services also entails market-based financing.

Open-market-raised capital alone is not appropriate for all local government activities, because not all municipal functions produce adequate revenue to be debt-financed in this way; grant and/or equity funds are also required, and careful analysis is necessary to identify the appropriate combination of market and nonmarket resources in each situation. The transition to private financing for municipal infrastructure has led many countries to realize that the roles of the private sector and public sector in providing resources must be more clearly defined. The assessment found that such a framework is lacking, and greatly needed, in Zimbabwe.

7.3 The Interest of USAID/Zimbabwe in Municipal Finance

The work carried out to analyze Zimbabwe's municipal bond markets took place under the Zimbabwe Private Sector Housing Program (PSHP). USAID and the Government of Zimbabwe (GOZ) are working in partnership to implement the PSHP. Initiated in 1992, the program is designed to enact policy changes in order to promote private-sector-based solutions to Zimbabwe's urban development needs, and to date has resulted in the provision of a substantial number of units of housing.

By addressing the major policy obstacles to the sustained production of low-cost housing, the Private Sector Housing Program is expected to achieve the following results:

- Increase the production of affordable housing for low-income households;
- Increase levels of private mortgage financing for low-income households with the introduction of new financial instruments and a modified financing incentive structure;
- Increase the role of the private sector in housing construction, land development and housing finance through a greater reliance on private developers, planners, surveyors, builders, and finance institutions;
- Expand the production of lower-cost building materials and increase related employment opportunities as a consequence of improved efficiency and capacity in the private construction and building materials industries; and
- Broaden and deepen the financial sector through the creation of new financial instruments and increased competition that will facilitate expanded investment and growth.

PSHP funding is used to service plots and to construct affordable houses for the low-income households within the local authorities participating in the program. Off-site infrastructure may

² This report uses the U.S. terminology that refers to debt instruments issued in capital markets as "bonds," not as "stocks," as these instruments are sometimes referred to in Zimbabwe.

be financed under the PSHP provided the repayments for capital costs and interest can be absorbed within the affordability levels of the target beneficiaries. Otherwise, most off-site infrastructure works such as water storage tanks, trunk water and sewer lines, trunk roads, and sewage treatment plants needed to serve the PSHP and other projects are funded by urban councils. Urban councils obtain the bulk of this financing from the government's Public Sector Investment Programme (PSIP) (see below) or from their own-source revenues. In this respect, the success of PSHP is dependent on the availability of resources for municipal finance.

7.4 The Current System for Municipal Finance in Zimbabwe

The current municipal finance system in Zimbabwe makes funds available to local authorities for capital investment purposes from a number of sources, both public and private. The system operates under a set of incentives that are unique to Zimbabwe, and is governed by a number of policies, controls, and regulations that affect the behavior of participants in the system and constrain the amount of resources that are available. As a result, the system is restricted in size and appears to be unable to meet the potential demand for municipal infrastructure investment capital, although the precise level of this demand is difficult to quantify.³

Public sector funds are provided from the urban councils' own reserves and internal borrowing, and from GOZ funds allocated through the Public Sector Investment Programme (PSIP) mechanism. Other funders of the PSIP include the World Bank and USAID.

Private sector funds are borrowed by cities mostly from insurance companies and pension funds either directly as loans, or indirectly through the institutions' purchases of municipal bonds. Municipal bonds are prepared for issuance by discount houses and merchant banks and sold on an allocation basis. Discount houses in some cases also purchase municipal bonds for their own portfolios. Commercial banks do not invest in municipal bonds, but do provide municipalities with checking services and overdraft accounts or lines of credit, a type of short-term loan.

Zimbabwean pension funds and insurance companies are subject to a prescribed asset requirement, and the current market for municipal debt can be partially attributed to this requirement. Under this policy, the GOZ requires that a certain percentage of the institution's assets be held in designated ("prescribed") investment vehicles, generally government debt instruments (short-term GOZ notes, long-term GOZ gilts, or municipal bonds). The prescribed asset requirement may originally have been motivated by prudential objectives (ensuring safe investments were made by financial institutions), but remains in place today as a fiscal mechanism that ensures the public sector preferential access to the domestic financial markets.

Both the bonds issued and loans taken out by local authorities qualify as prescribed assets on the balance sheets of the investor institutions, and because there is generally a shortage of these assets, municipal bonds are often oversubscribed when first issued. The statutory prescribed assets requirement is 45 percent of assets (55 percent prior to May 1997, and down

³ The term "municipal finance" is used in this report to mean financing for the provision of services by a local government or its instrumentalities. In Zimbabwe, these local governments could include both urban and rural district councils or any local government entity borrowing funds for service provision, although the emphasis in this report is on urban councils.

from an earlier 60 percent level). However, in practice some institutions appear to keep the level as low as 35 percent.

The prescribed investment requirement influences the pricing of debt instruments, generally keeping interest rates artificially low. This is especially so when government commercial paper and gilt (treasury bond) sales take place only at or below a posted interest rate that is below market and when there is excess demand for the paper because there has been a shortage of issues that qualify as prescribed investments or a shortage of long-term investments generally.

Currently, all municipal bonds are considered to carry a GOZ guarantee. Whether these guarantees are implied or provided in statute was not determined during the analysis, but the universal assumption of those involved in issuing and purchasing bonds is that the approval of borrowing powers by the GOZ—which is required before a local authority can borrow in the open market—carries with it a full faith and credit guarantee of the GOZ. Bonds are purchased by investors based on (1) the strength of the perceived GOZ guarantee and (2) the financial analysis of the project performed by the Ministry of Local Government, Rural and Urban Development (MLGRUD) and the Ministry of Finance (MOF); financial institutions perform little or no credit analysis of their own. Direct loans are not considered to carry the GOZ guarantee, although urban councils must obtain permission before such a borrowing takes place and the loans qualify as prescribed assets.

Zimbabwe's treasury finance system is in some respects an asset that can support the development of an expanded municipal finance system. Because the GOZ issues treasury securities in the open market to finance government activities, systems are in place for listing and trading government securities, investors are accustomed to holding securities of the public sector, and interest rates on treasury instruments can serve as the baseline (or "reference rate") for pricing municipal securities.⁴ International experience seems to show that having a system of treasury finance, as Zimbabwe does, can be an advantage when a country is attempting to develop municipal finance mechanisms, even though the municipal financial instruments will be different from treasury securities.

In other ways, Zimbabwe's treasury finance system may deter local government finance. The principal deterrent is the competition for funds between the GOZ and local authorities, a situation that is largely under the control of the GOZ. The GOZ guarantee of urban council debt makes it, in effect, GOZ debt and puts the urban councils in the queue behind the GOZ when domestic financing is being allocated. A primary reason why the prescribed investment regime exists is to finance various needs of the GOZ and some of its parastatals, including their budget deficits. But the amount of funds that can be borrowed on the domestic financial market is finite, and the ability to borrow internationally, limited.

While municipalities benefit from the lower rates that may result from prescribed investments in the short run, they become the standard for all government financing, stifling innovation,

⁴ Central government securities are generally considered very low risk, or risk-free, because of the depth of resources available to repay them. Central government interest rates are sometimes referred to as "risk-free" rates. Municipal securities are considered somewhat higher risk, although the risk differential will vary depending on the local government and structure of the financing. Therefore the interest rates on central government securities will generally be the lowest in the market, and can serve as a basis for the pricing of other riskier securities.

crowding out potential lenders to the municipal sector who would require a higher rate of return, and allowing factors other than true market mechanisms to influence interest rates.⁵

The Financial Sector

The financial sector in Zimbabwe is sophisticated and quite diverse, especially considering the size of the private economy. The sector includes merchant banks, commercial banks, building societies, and discount houses (which not only trade securities, but also invest for their own portfolio, and prepare bond issues for local authorities and others). Leasing companies, are active, although they do not currently appear to be serving the municipal sector. There are a number of unit trusts (mutual funds investing the funds of multiple individual investors), although none has invested to date in municipal bonds.

Current non-bank institutions in the financial market include pension funds, such as the Local Authorities Pension Fund, and insurance companies.

New institutions entering the financial market recently include merchant banks, trade financing vehicles, *bureaux de change*, and money brokers.

Certain financial functions are missing from the sector at present. There are no credit rating services for the municipal sector, although a committee of banks recently met to discuss the need for expanded credit rating services in Zimbabwe. There is no swap market, so nearly all lending is done at fixed interest rates, in order to reduce the risk to the banks.

Local governments and the GOZ are able to borrow long-term funds up to 20 years largely on the strength of GOZ guarantees, but for other borrowers, the longest term funds available fall in the 5- to 8-year range. Project finance activity and experience are very limited. In general, Zimbabwean financial institutions follow a fairly conservative approach, which is probably rational given the constraints imposed by the regulatory regime and the absence of both internal and external credit analysis.

The new direction in the financial sector is toward more competition, with increasing emphasis by the government on supervision rather than regulation. In spite of the restrictions now in place, there is a spirit of entrepreneurship in the Zimbabwean financial sector, and a surprising amount of experimentation taking place, along with strategies to develop new products and client groups. The further liberalization of the financial sector, which is widely expected, is welcomed by most of those involved, and should be good for the municipal sector.

Except for the few financial sector professionals in Zimbabwe working directly with cities (some of whom have work experience in the municipal sector), most of those working in the financial sector have limited access to information about the operations and performance of urban councils. This information gap makes it difficult for the financial sector to design and offer services to the municipal sector, yet there is still interest by financial professionals in developing services and offering financial market access to urban councils. Efforts to expand the

⁵ In other cases, it was suggested, prescribed assets may result in higher-than-market rates, when financial institutions are compelled to lend at inconvenient times and charge borrowers a penalty for doing so.

information flow between the financial sector and local government are needed; these could have a very positive effect on the development of the municipal finance market.

The Municipal Sector/Intergovernmental Relations

Zimbabwe maintains a categorical distinction between its urban and rural local governments or councils. The urban councils, which are governed by the Urban Councils Act, number 22, including 5 cities (Harare, Bulawayo, Mutare, Gweru and Kwekwe); 7 municipalities (Chitungwiza, Masvingo, Marondera, Kadoma, Chinhoyi, Chegutu and Redcliff); 8 Town Councils or Boards (Karoi, Bindura, Gwanda, Rusape, Shurugwi, Kariba, Norton and Victoria Falls); and 2 Local Boards (Hwange and Ruwa). The Urban Councils Act was last updated in 1995, and is being revised again in 1997.

The Urban Councils Act governs the 22 urban councils closely, laying out the requirements associated with a wide range of urban powers, from the organization of elections to the contracting of sidewalk construction. While delegating a large and diverse group of functions to the urban councils, the Act at the same time reserves considerable oversight, approval, and intervention powers for both MLGRUD and the President. One of those reserved powers is the requirement for approval of rents and other charges in "high density" (i.e., low-income) areas within the urban council area.

Population of urban councils ranged from an estimated 1.39 million for Harare to 6,000 for Ruwa, with total urban population estimated at 3,216,800 in 1995. Revenue ranged from Z\$881⁶ million for Harare to Z\$6.2 million for Hwange in the 1995/96 fiscal year. Average per capita revenue of the 22 urban councils in 1995/96 was Z\$692, ranging from Z\$1,508 in Victoria Falls down to Z\$271 in Hwange .

The financial condition of urban councils varies considerably, but until recently had generally improved over the past several years. Urban council revenues come from a variety of sources, the principal ones being tariffs for water, sewerage, and solid waste, as well as taxes (including property taxes or rates). Urban councils receive income from their enterprises as well, including liquor sales. Revenues from liquor sales figure prominently in the income of certain councils, such as Chitungwiza, where liquor sales made up more than one-third of the council's income in 1995/96.

Improvements in the financial condition of urban councils observed until recently were due to a considerable extent to the work on Financial Recovery Plans (FRPs) initiated by MLGRUD and the Ministry of Public Construction and National Housing (MPCNH) now continued under The World Bank's Urban Sector II ("Urban II") projects. The Urban I and Urban II projects have provided debt funds to urban councils through PSIP, and assisted in strengthening the financial management capacity of the councils, expanding the use of audits and information systems and encouraging the adoption of Financial Performance Plans (developed from the FRPs) and Strategic Plans. The financial condition of urban local authorities has been adversely affected recently by funding changes in the health sector.

⁶ At the time of this report, the exchange rate in the Zimbabwe market was approximately Z\$11.2 = US\$1.

Urban councils have relatively sophisticated accounting systems that allow all local government functions to be viewed as enterprises with their own costs and revenues. This system provides management information to municipalities about the “profitability” of various services that allows management intervention, policy change, and municipality-to-municipality comparisons.

Zimbabwean urban councils have experience with borrowing and the repayment of debt. The repayment performance of the PSIP is reportedly good; similarly, no bond or municipal loan defaults were reported.

Capital budgeting and capital expenditures data are not systematically reported by urban councils, making it difficult to provide an estimate of either total demand for capital investment funds or actual investment. At fiscal year end 1995, the MLGRUD report on 1994/95 budget performance and 1995/96 budgets showed a cumulative capital expenditure estimate for the 22 urban councils of Z\$1.7 billion for 1995/96. Reports provided of 1995/96 financial results did not include capital expenditure results; however, nearly one-half of the councils had operating deficits for the 1995/96 fiscal year, suggesting a significant shortfall in these expenditures.⁷

Future demand for capital funds for municipal services in Zimbabwe will come not only from urban councils, but also from the 57 Rural District Councils (RDCs) where the great majority of the country’s population resides.

Consultants to the World Bank recently estimated the RDC’s 5-year demand for investment funds at Z\$427.5 million.⁸ Assuming some RDCs will have the financial capacity and resources to also participate in the municipal finance marketplace, the financing needs of these councils should be considered simultaneously with those of the urban councils, where appropriate. This would expand the overall size of the municipal finance market, and encourage its development by reaching better economies of scale, thereby generating interest among a larger number of potential investors.

Other Organizations

Two local organizations are potentially very important in the development of a municipal finance system in Zimbabwe. These include the Treasurer’s Forum of the Urban Council Association of Zimbabwe and the Institute of Finance & Accountants.

A number of international donor organizations have urban development and finance activities in Zimbabwe, including the World Bank, the Nordic Development Fund (co-financing the institutional development component of Urban II), the British Overseas Development Agency (which is supporting the Rural District Council Capacity Building Program), and the United Nations Development Programme (recently carrying out a study on tax burdens for the Ministry of Finance), as well as USAID.

⁷ Elsewhere, the World Bank office in Harare has estimated urban council primary/offsite infrastructure works in progress or planned for the period July 1997 through December 1998 at over Z\$1.4 billion, of which approximately Z\$19 million (1.34 percent) could be met from urban council own resources. (Internal report.)

⁸ Diana Conyers and Ben Hlatshwayo, *The Capacity of the Rural District Councils to Absorb Capital Development Funding*, report prepared for MLGRUD, at the request of the World Bank, June 1996.

7.5 Adequacy of the Current System

The current system of capital financing is inadequate to provide the urban infrastructure needed by a growing and urbanizing Zimbabwe. Without modernization, the current system will continue to impede Zimbabwe's development and economic integration. Significant resources exist to develop an improved system, as described later in this section. The principal reasons for pursuing a more market-based municipal finance system are as follows:

Need to Address Infrastructure Financing Gaps

Local authorities are meeting only a portion of their infrastructure financing needs under the current system, resulting in (1) reduced service levels for citizens, (2) reduced credibility of the local government, (3) increased costs as estimates rise due to inflation during funding delays, and (4) ultimately, slower development for the country. The current budgeting system does not appear to produce capital budgets that reflect actual investment needs or capacity to deliver investments at the local level, making capital market planning very difficult.

Yet lack of funds is not the only constraint: own-source revenues, grant funds, and/or private funds are needed to serve as project equity; more information is needed about the financial condition and capital requirements of urban councils; feasible, economically viable projects have to be developed; private partners need to be identified where appropriate; and municipal capacity will have to be demonstrated. Standards and procedures for developing good projects will only be established and followed once there is some promise that funds will ultimately be available.

Need to Further Decentralize Governmental Decisionmaking

The development of an enhanced financing system will be facilitated by GOZ willingness to devolve more financial decision-making to the local level. The current system encourages dependency by local governments on the technical capacity of the GOZ, and discourages local experimentation. Interventions such as the fee approval process add uncertainty to the revenue-raising process, and therefore increase the perceived risk of a municipal investment by investors. (Private partners will have similar concerns; broader revenue powers will need to be delegated to the urban councils if private partnerships in urban service delivery are to succeed.)

Need to Reduce the Opportunity Costs of the System

Delays are now built in to the current municipal financing system that create enormous opportunity costs for municipalities. These are hidden costs that can sometimes be hard to quantify, but that result in increased costs or reduced revenues over time. Examples of opportunity costs being experienced in the current municipal finance system include: (1) increases in project costs due to inflation during waits waiting for funding, (2) delays in revenue increases due to time lags in completing improvements, (3) extra carrying costs (especially interest costs) that result from delays on projects already under construction that are awaiting incremental funding approval, and (4) extra costs budgeted by contractors to compensate for uncertainties in project start and completion dates and payment schedules.

Need to Provide Resources on a Sustainable Basis

The current financing system is not sustainable. It relies on the good will of donors, unpredictable GOZ contributions, and financial sector controls that may not be in place much longer. It is not sustainable economically because of the backlog of needed investment that it is helping to create.

The ideal municipal finance system is one which is based on appropriate and predictable sources of funds coming from both the public and the private sector, combined in ways that the resulting investments are affordable for users and attractive to investors. A sustainable system will attract capital by presenting attractive investment projects that acceptably balance risk and return. Such an ideal system may take some time to develop, but the goal of a new system in Zimbabwe should be to ensure sustainability to the extent possible. The involvement of the financial sector in the design of the new system and its lending mechanisms will be critical to ensure that private investment opportunities are maximized.

The sustainability of a municipal finance system is also related to its efficiency, meaning in this case the minimization of costs for issuing, trading, and repaying loans, bonds or other financial instruments. Bonds are generally considered very efficient because of their low transaction costs, but generally only once financing needs reach a certain size. In systems with many smaller borrowers, such as Zimbabwe, other types of intermediaries are sometimes created to access capital on behalf of borrowers. A multiproject or pooled financing vehicle, for example, raises funds in the market using bonds or other financial instruments and then make loans to local governments for qualified purposes. These types of mechanisms should be explored in Zimbabwe.

7.6 Developing a Municipal Infrastructure Policy

In general, Zimbabwe lacks a policy framework for supporting a sustainable system for operating and financing all urban services. Such a framework would systematically address many of the issues covered in the assessment, and would assist the urban (and rural) councils in identifying costs and benefits, setting minimum delivery levels, estimating investment needs, and identifying resources for delivering them. It would also clarify the role that the GOZ is willing to play in the provision of resources at the local level, and guide all participants, including local governments, private partners, financial institutions, donors, and vendors.⁹

⁹ South Africa has recently put in place a comprehensive policy framework for infrastructure finance that might serve as a useful model for an overall municipal finance strategy in Zimbabwe. See *Republic of South Africa: Municipal Infrastructure Investment Framework*, Ministry in the Office of the President, and the Department of National Housing, 25 October 1995.

7.7 Critical Constraints on an Expanded Municipal Finance System

A sustainable municipal finance system can be seen as having three components: (1) markets operating according to commercial principles, (2) appropriate mechanisms and financial instruments, developed specifically for municipal purposes; and (3) disciplined financial management practices at the local government level. A number of the constraints that exist now in Zimbabwe keep these components from developing and, as a result, keep a more commercial municipal finance system from emerging. Some, such as the macroeconomic constraints on the overall financial system, are beyond the control of the people and institutions most directly involved in municipal finance issues in both the public and the private sectors. However, these individuals and institutions stand to gain if decision-makers on these matters can be helped to understand how municipalities, and the country as a whole, will benefit if these larger reforms are carried out.

A summary of current constraints is shown in Table 7.1.

Table 7.1 Summary of Current Financial Constraints in Zimbabwe

Municipal Constraints
P Adequate information is not available on the financial condition and organization of the municipal sector.
P Urban councils are forced to function under an unsustainable system of operating cross-subsidies.
P Urban councils lack adequate control over local government borrowing and tariff-setting.
Financial Sector Constraints
P Government controls distort decision-making and discourage investment in the municipal sector.
P The private bond market is still in development; lack of secondary trading and short debt terms will need to be addressed.
P Credit analysis and credit rating expertise for the municipal sector is limited.
P Even when fully developed, the municipal market will not be moderate in size.
Macroeconomic Constraints
P The GOZ's need to finance budget deficits limits the financing available to the municipal sector.
P Inflation and other macroeconomic conditions affect the quantity and terms of funds in the market.
P The current structural adjustment program requires the shifting responsibilities to the local level without fully addressing the financing needs of local authorities.

Policy and Regulatory Constraints

- P A policy framework for municipal finance is needed that defines goals, quantifies demand for capital, and clarifies roles and responsibilities.
 - P The GOZ transfers to urban councils are unpredictable.
 - P The GOZ maintains broad prerogatives to intervene in the budgeting and management of urban councils.
 - P Urban and rural councils lack a unified system of finance with the same budgeting and accounting standards.
 - P Commercialization/privatization and municipal finance activities need to be carried out in a coordinated manner.
-

Summarized below are recommendations that have been made to the government of Zimbabwe and to USAID.

7.8 General Recommendations for Zimbabwe

1. Develop a national policy framework for local government infrastructure finance, with the assistance of interested parties, that addresses (among other things) the infrastructure investment need, the GOZ/local government relationship, and the role of the private sector.
2. Create a mechanism for ongoing public-private dialogue on municipal finance market development that can include financial institutions, existing investors, GOZ and local government officials, and the private sector.
3. Address the macroeconomic conditions and regulatory impediments that constrain the development of an active municipal finance market.
4. Develop and begin implementation of a transitional strategy, from the current municipal finance system to an expanded, more market-based system, that will take into consideration other economic reforms that will be taking place in Zimbabwe over the next few years, and ultimately result in an expanded open market system of municipal finance.
5. Move forward simultaneously on commercialization, privatization, and municipal finance market development, as related strategies.

7.9 Recommendations for USAID

1. Work on developing a secondary mortgage market and municipal finance market simultaneously at the policy level, since the issues underlying them are very similar.

2. Facilitate the development of a public-private sector dialogue on municipal finance by co-sponsoring a conference on the topic of municipal finance.

3. Seek support at the conference for creation of a policy framework on municipal infrastructure finance. Design and support a process for its creation.

4. Coordinate with the World Bank to help ensure that the new Local Government Capital Development Project addresses the recommendations in this report. In particular, coordinate on policy development activities, and evaluate the feasibility of using the loan funds as co-financing on municipal projects where private financing is being sought.

5. Provide targeted technical assistance on one or more municipal finance issues instead of a more detailed municipal bond market study. Potential areas for assistance might include: design of a transitional strategy for the deregulation of the current municipal finance market, a capital planning exercise with local authorities, or development of models for public-private co-financing.

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